

# The Donative Theory of the Charitable Tax Exemption

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It is extraordinary that no generally accepted rationale exists for the multi-billion dollar exemption from income and property taxes that is universally conferred on "charitable" institutions.<sup>1</sup> Due primarily to the vast array of activities to which the exemption has been applied, it has defied all past attempts to formulate a synthesizing concept of charitable.<sup>2</sup> Most commentators

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<sup>1</sup> The most prominent manifestation of the exemption is § 501(c)(3) of the Internal Revenue Code ("I.R.C." or "Code"), which exempts from corporate income taxation organizations that are "organized and operated exclusively for religious, charitable, . . . or educational purposes . . . ." I.R.C. § 501(c)(3) (1988). Similar provisions exist in the statutory or constitutional law of virtually every state with respect to property taxation. See W. WELLFORD & J. GALLAGHER, UNFAIR COMPETITION? THE CHALLENGE TO TAX EXEMPTION app. 153 (1988) (50-state survey of the laws of charitable property tax exemption).

The federal exemption originated in 1894, but the first income tax and state property tax exemptions arose centuries earlier, following the tradition set in medieval England. See J. JENSEN, PROPERTY TAXATION IN THE UNITED STATES (1931); Adler, *Historical Origin of the Exemption From Taxation of Charitable Institutions*, in WESTCHESTER COUNTY CHAMBER OF COMMERCE, TAX EXEMPTIONS OF REAL ESTATE: AN INCREASING MENACE (1922). Indeed, the historical roots of the charitable exemption can be traced back to ancient Greek and Roman times; Liles & Blum, *Development of the Federal Tax Treatment of Charities*, 39 L. & CONTEMP. PROBS. 6 (1975). Sierk, *State Tax Exemptions of Non-Profit Organizations*, 19 CLEV. ST. L. REV. 281, 282 (1970) ("Real property taxation, and exemption therefrom, seems to be about as old as history. . . . One historian reports that the 'economic equilibrium of the state was endangered' by the fact that the tax exempt temples owned fifteen percent of the cultivable land and vast amounts of slaves and other personal property during the reign of Ramses III about 1200 B.C.").

The universal character of the charitable exemption extends internationally. A survey of 10 other countries, both eastern and western (Austria, Belgium, Hungary, Israel, Italy, Spain, Taiwan, Thailand, United Kingdom, and Germany) found that all conferred an exemption from corporate income tax and from some form of *ad valorem* taxation on nonprofit entities that we would classify as charitable, although the particular listings and descriptions varied. B. WEISBROD, TAX POLICY TOWARD NONPROFIT ORGANIZATIONS: AN ELEVEN COUNTRY SURVEY (1990).

<sup>2</sup> For example, the most frequent explanation for the exemption is that the government should not tax entities that relieve it from burdens it would otherwise have to bear itself. *Bob Jones Univ. v. United States*, 461 U.S. 574, 591 (1983) ("charitable exemptions are justified on the basis that the exempt entity confers a public benefit—a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues"). However, this explanation is underinclusive since the charitable exemption covers many activities such as museums and the performing arts that the government has no obligation to undertake, or, in the case of religion, is prohibited from undertaking. The most favored alternative theory is that the exemption is used to support activities that provide a benefit to the community. *Walz v. Commissioner*, 397 U.S. 664, 672-73 (1970) ("certain entities that exist in a harmonious relationship to the community at large, and that foster its 'moral or mental improvement,' should not be inhibited in their activities by property taxation . . . . The State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life . . . ."). However, this explanation, standing alone,

therefore have resorted to a theoretic pluralism, or agnosticism, maintaining that no single theory is capable of capturing the nuanced contours that historically have shaped the charitable exemption.<sup>3</sup> This is an unsatisfactory explanation, however, for it ignores the unitary structure of the charitable exemption, which uses the single concept of charity to define its scope. Denying that this concept has any definitional content means that "charitable" is applied as a completely open-textured term to activities that are considered deserving of an exemption for a multitude of undisclosed policy reasons. Because we lack a coherent descriptive concept of what charities are, no normative explanation for why they should be exempt from taxes emerges for critical examination.

This unprincipled state of affairs is so taken for granted that the fundamental basis for the exemption is hardly discussed.<sup>4</sup> In a previous article,

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overinclusively sets no subject matter limits whatsoever since any social or economic activity potentially benefits the community. Other discredited theories are discussed *infra* in text accompanying notes 8-18.

<sup>3</sup> See H. Dale, Rationales for Tax Exemption 1 (1988) (unpublished manuscript) ("[N]o single rationale can or should be expected to explain or justify tax-exempt status. The not-for-profit sector of our society is complex and varied; its lineage is ancient. It would be unreasonably simplistic to expect to capture its essence or justification within the compass of any theory."); see generally P. SWORDS, CHARITABLE REAL PROPERTY TAX EXEMPTIONS IN NEW YORK STATE (1981). In one sense, we agree with Professor Dale that not all exemptions can be explained by a single theory. We recognize, for example, that a perfectly good reason for exemption is the common-sense notion that the government should not tax itself, and hence government-funded institutions should be exempt; there are also many other valid reasons for granting exemption. See *infra* note 22. In this paper, we seek only to justify the *charitable* exemption. To the extent our system provides exemption because an entity is deemed "charitable," it presupposes that the label "charitable" has some substantive content, and that entities deserving of the label also deserve exemption. Our theory, therefore, confines itself to explaining what the substantive content of the word "charitable" should be. Obviously, Congress and the states could simply repeal laws granting exemption because of charitable status and make exemption judgments on a case-by-case basis. Until they do, however, we feel compelled to seek some reasonable explanation for why and when "charitable" status should invoke tax exemption and a variety of other tax benefits.

<sup>4</sup> "[T]hink[ing] more seriously about what is meant by the concept of charity [is] a task that is about four hundred years overdue." H. Hansmann, The Two Independent Sectors, A Paper Presented at the Independent Sector Spring Research Forum 5 (March 17, 1988) (unpublished manuscript); see also Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, in 4 U.S. DEP'T OF TREASURY, RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2031 (1977) [volume as a whole hereinafter COMMISSION PAPERS] (the original federal adoption of the exemption occurred "without debate and virtually without comment;" "The Congressional Record will be searched in vain for any fuller expression of the policy underlying the exemption" than so that these institutions "'may not suffer under the bill.'" (quoting Congressman Tucker, who introduced the amendment containing the exemption); Bittker & Rahdert, *The Exemption of*

we helped fill this void<sup>5</sup> by critiquing the conventional and academic theories of the exemption.<sup>6</sup> We applied four evaluative criteria to demonstrate that each of the previously expounded theories fails to explain why the activities the exemption encompasses should receive an implicit subsidy through the tax system.<sup>7</sup> In order to place the exemption on firmer theoretical footing, we then proposed a donative theory of the charitable exemption—one that considers as charities only those institutions that are capable of attracting a substantial level

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*Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 302 (1976) (Congress has “grop[ed] along, enunciat[ing] no developed theory”).

<sup>5</sup> In 1976 and 1981, the *Yale Law Journal* published two innovative, carefully argued theories of the income tax exemption for charities, Bittker & Rahdert, *supra* note 4; Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981) [hereinafter Hansmann, *Exempting Nonprofit Organizations*], but these ideas generated essentially no response until recently. The only direct response other than our own is that of Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C.L. REV. 501 (1990); for reasons explained in Hall & Colombo, *Nonprofit Hospitals*, *infra* note 6, at 377-78 & nn.270-74, his response is directed more to the descriptive question of categorizing various nonprofit entities than to the normative question of why they should be exempt. The analytical framework for Atkinson's insightful critique of Hansmann and Bittker differs sharply from ours: rather than defining a set of normative criteria for evaluation, he proceeds by extensive description of how their theories compare with his concept of altruism in nonprofit organizations. Atkinson, *supra* at 601 (“I will let the theorists speak in their own terms, pointing out differences between the classes of organizations they discuss and the altruistic nonprofits I have identified. . .”). Atkinson offers as an alternative to these theorists the argument that nonprofits should be subsidized simply by virtue of their altruistic nature, a theory that superficially resembles the donative theory that we arrived at independently. Atkinson's altruism theory is quite distinct from ours, however: first, as discussed in Part II.A.5 below, it covers a much larger scope of activity (essentially any legitimate nonprofit firm) and, second, he offers very little normative basis for adopting this theory. See Hall & Colombo, *Nonprofit Hospitals*, *infra* note 6, at 377 nn.270-74; Atkinson, *supra* at 628, 630 (“It would be logical for me here to prove that altruism really is a good thing and thus worthy of tax favors. But that is too ambitious. . . . [It] is not a matter of logical proof, but of faith, of freely chosen values and visions.”). We undertake the normative explanation that Atkinson declines, and, by so doing, we demonstrate that his altruism theory extends far too broadly.

<sup>6</sup> Hall & Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991) [hereinafter Hall & Colombo, *Nonprofit Hospitals*].

<sup>7</sup> We follow the prevailing view that the charitable exemption constitutes an implicit government subsidy to the activities it covers since it is an obvious deviation from the ordinary tax base—either income or property. *Regan v. Taxation Without Representation*, 461 U.S. 540, 544-45 (1984) (“tax exemptions . . . are a form of subsidy that is administered through the tax system”). See generally S. SURREY & P. MCDANIEL, *TAX EXPENDITURES* (1988). The contrasting view looks for a justification of the exemption that would explain why charitable income or property is not in the tax base to begin with. See P. SWORDS, *supra* note 3, at 200; Bittker & Rahdert, *supra* note 4, at 333. Additional reasons for rejecting this minority view are developed in Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 379-81.

of donative support from the public. We then demonstrated that this theory convincingly meets each of the four criteria that other exemptions fail. This Article expands on the donative theory of the charitable exemption, first by summarizing the basic theory as it contrasts with conventional alternatives, then testing this theory against a number of possible objections, and finally describing how the exemption should be administered under this theory.

## I. THE DONATIVE THEORY IN BROAD OUTLINE

### A. *Deservedness*

The most important criterion for evaluating a theory of the charitable tax exemption is deservedness, which has two distinct components: whether the theory identifies activities that are both worthy of, and in need of, a social subsidy. The chief example of a conventional theory that fails the first component of deservedness—worthiness—is the theory that uses charitable trust law to define the scope of the tax exemption. This body of law, which has evolved since before the enactment of the 1601 Statute of Charitable Uses,<sup>8</sup> contains essentially no subject matter limits to its coverage. It indiscriminately enforces trusts that pursue any *public* purpose that a founder might choose.<sup>9</sup> As one court has declared, charity, so conceived, is “broad enough to include whatever will promote, in a legitimate way, the comfort, happiness, and improvement of an indefinite number of persons.”<sup>10</sup> It is manifestly absurd to

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<sup>8</sup> Trust law gives special treatment to those trusts it considers charitable by exempting them from the requirements of a definite term of existence and an identifiable class of beneficiaries, and by protecting the terms of their creation through enforcement by the attorney general. This Elizabethan statute is the seminal enactment that codified this protective attitude. Its preamble contains an historic listing of objects considered charitable at the time, which listing has had enormous influence over the subsequent case law's attempts to further define this term. *See generally* G. BOGERT, TRUSTS (6th ed. 1987); 4A A. SCOTT & W. FRATCHER, THE LAW OF TRUSTS (1989).

<sup>9</sup> The leading decision declares that charitable covers all “purposes beneficial to the community.” *Commissioners v. Pemsel*, [1891] A.C. 531, 583; *see also* *Ould v. Washington Hosp.*, 95 U.S. 303, 311 (1877) (charity includes “any thing that tends to promote the well-doing and well-being of social man”); *Wilson v. First Nat. Bank*, 164 Iowa 402, 412, 145 N.W. 948, 952 (1914) (“The word ‘charity,’ as used in the law, . . . includes substantially any scheme or effort to better the condition of society or any considerable part thereof.”). The only limitation these statements imply, and indeed the only limitation trust law enforces, is to disqualify charitable trusts that confer only private benefit or that are organized and operated in an inappropriate manner, such as to create a conflict of interest in the trustee. *See infra* note 10.

<sup>10</sup> *Harrington v. Pier*, 105 Wis. 485, 520, 82 N.W. 345, 357 (1900). Beyond this basic requirement of publicness, the only limits charitable trust law sets are organizational and operational constraints on the manner in which the activity is conducted, constraints such as nonprofit status and a prohibition of operating the trust for the benefit of those who

confer billions of dollars of public subsidy on activities for no other reason than that, if they were organized as trusts, the law would not refuse to enforce the trust terms.

Other theories more discriminating in their determination of worthiness are nevertheless flawed under the deservedness criterion because they do not explain why valued activities *need* support to exist at a socially optimal level. A prime example is the community benefit theory, which seeks to ascertain which activities are more desirably offered on a nonprofit than a for-profit basis. This theory is flawed because, even assuming society has a preference for nonprofit enterprise, it fails to explain why a subsidy is needed to effectuate this preference. For instance, even if we accept the (unproven) argument that nonprofit hospitals are superior to for-profits, doctors and patients are free to patronize nonprofits to the full extent they desire. Therefore, there is no basis for providing a social subsidy to assist in realizing this choice.<sup>11</sup> The exemption is either a waste or a windfall.

The donative theory avoids these twin pitfalls in the deservedness criterion by deriving its concept of charity from the failure of the private sector to supply goods and services that are not sold efficiently through individual transactions. It reasons that donative institutions deserve a tax subsidy because the willingness of the public to contribute demonstrates both worthiness and neediness. Donors' selections of particular objects of philanthropy from the many available alternatives reveal those that are of special worth in the public's estimation. The institution's resort to solicitations evidences that its needs are not being met elsewhere. We can be assured that donations themselves will not fully satisfy this need since donors do not lightly relinquish their assets; in the absence of a quid pro quo return, the free rider incentive that affects the motivation to give tells us that donors systematically will give less than the deservedness that they perceive (as measured hypothetically by their willingness to purchase the good if it were capable of being delivered in ordinary market transactions). Hence, the existence of substantial donative support from the public at large signals the need for an additional, shadow subsidy to take up the donative slack.

### B. Proportionality

After determining what activities deserve a social subsidy, the next difficulty in understanding the charitable exemption is formulating a theory that reasonably tailors the level of subsidy to the level of deservedness so as not to grossly over- or undersubsidize the activity. The primary hurdle this second

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control it. See generally M. CHESTERMAN, CHARITIES, TRUSTS AND SOCIAL WELFARE 316 (1979); L. SHERIDAN & G. KEETON, THE MODERN LAW OF CHARITIES 32-50 (3d ed. 1983); Atiyah, *Public Benefit in Charities*, 21 MOD. L. REV. 138 (1958).

<sup>11</sup> Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 367-68.

inquiry presents is why should deserving activities be subsidized through the tax system rather than by a more targeted form of direct subsidy that would almost surely be more accurate? A leading example of a theory that fails this proportionality criterion is one that limits the exemption to organizations that provide some measure of free services to the poor. Under this theory of the exemption, a tax subsidy produces an upside down effect as between qualifying entities that provide a small percentage of free services and those that provide a large percentage: those charities that provide the least free services will have the most exempt property and income, all else being equal. Therefore, the charity-care theory perversely provides the most aid to those activities that least deserve support, among the entities that qualify.<sup>12</sup>

The donative theory on first inspection also appears to suffer somewhat under the proportionality criterion. While a donative subsidy is not perverse in its effect, at best there is only a rough relationship between an institution's donative support and the amount of its exempt property or income. There is an approximate relationship with respect to exempt *property*, but there is some question whether the *income* tax exemption provides a subsidy at all, given that gifts would not count as income even absent the exemption.<sup>13</sup> However, a second aspect of the donative theory—government failure—explains that, by definition, no superior subsidy alternative exists. The donative theory operates at the intersection of the failure of both private markets and the government.<sup>14</sup> Only when neither sector is capable of providing a shared social benefit at the desired level will a substantial number of people resort to philanthropy. This observation establishes why the donative theory elegantly satisfies the proportionality criterion: The political stalemate that prevents a direct government subsidy means that, however flawed, an implicit subsidy through the tax system is the only available mechanism for subsidy.

### C. *Universality and Historical Consistency*

A fully successful theory of the exemption must also satisfy two criteria of secondary, but still considerable, importance. The first, a criterion of universality, derives from the fact that the charitable exemption is structured as a unitary, coordinated system composed of a host of benefits and burdens that flow automatically from the determination of charitable status. Charitable organizations at once qualify for exemptions from both local property taxes and federal corporate income tax; these "501(c)(3) organizations" are also eligible

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<sup>12</sup> Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 349-50. Other theories of the exemption distribute support randomly or unpredictably with respect to their definition of deservedness. *See id.* at 361-72, 379-83.

<sup>13</sup> *See id.* at 403 n.342; Bittker & Rahdert, *supra* note 4, at 308-09.

<sup>14</sup> This "twin failure" theory is developed in more detail in our prior article, Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 386-90.



under Code section 170 to receive contributions that are deductible in computing the donor's personal income tax. Tax-exempt status carries with it the requirements that the organization be truly nonprofit, that it limit its political lobbying and campaigning activities, and that it pay taxes on earnings unrelated to its exempt purpose. A successful theory of the exemption should explain most or all of these tax benefits and burdens.

A satisfactory theory of the charitable exemption should also be historically consistent with the major categories of exempt activities. Because the concept of charity explicitly refers to over 400 years of legal precedent, it would constitute an abandonment, not an explanation, of the charitable exemption to construct a theory that is oblivious to this history.

Some existing theories of the exemption fail to account for either of these considerations. For instance, Professors Bittker and Hansmann have proposed competing theories that would explain the federal income tax exemption but that have no relationship to the state property tax exemption.<sup>15</sup> Moreover, their theories fail to explain major restrictions on the exemption and give no coherent meaning to the term "charitable" that accords with established history and common sense understandings.<sup>16</sup>

In contrast, the outline form of the donative theory nicely satisfies the universality criterion. Those institutions that receive donative support deserve subsidy through all available tax mechanisms: income, property, and sales tax exemptions as well as the charitable deduction.<sup>17</sup> The theory therefore avoids treating each of these as a separate problem. Moreover, defining charities as those activities that receive substantial donative support is consistent with our intuitive and historical concepts of this term.

In particular, only the donative theory is capable of reconciling the charitable exemption's historical connection with the law of charitable trusts. On first inspection, it makes no sense for tax law to borrow its concept of charity from trust law, as it purports to do, since the functions of these two bodies of law, and the social costs of charitable characterization, are entirely different.<sup>18</sup> Focus on the donative element, however, explains this historical connection. Charitable trusts receive legal protection because of their donative

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<sup>15</sup> See *id.* at 385-89.

<sup>16</sup> For example, the only definitions that Bittker's and Hansmann's theories would offer for "charity" (in the context of the income tax exemption) are the awkward formulations (respectively) of any entity for which income is difficult to measure, or any socially valued nonprofit that suffers a comparative disadvantage in capital markets. See *id.*

<sup>17</sup> However, the donative theory would support only an exemption from donative entities *paying* sales tax on items *purchased*, not on their *charging* sales tax on items *sold*, because only the former is proportionate to their activities supported by donations whereas the latter relates to their commercial activities. But this limitation is in fact consistent with the prevailing pattern among the states, most of which confer the first type of sales tax exemption but not the second. See *id.* at 399 & nn.345-47.

<sup>18</sup> *Id.* at 332.

status: the self-sacrifice entailed in the founder's formation of the trust ensures that the object of the trust deserves at least the limited social support of legal enforcement. We argue that a donative act also deserves the additional social support entailed in the tax exemption. Only when we lose sight of this donative aspect of charitable trust law and blindly transplant its subject matter to tax law do we lose any rational subject matter limits. Therefore, retaining the crucial donative element maintains contact between modern tax law and the centuries of trust law precedent.

#### *D. The Challenge that Lies Ahead*

In broad perspective, the donative theory stands in fundamental contrast to other theories of the charitable exemption in the social engine that it uses to establish the exemption's proper scope. The theory that refers to the law of charitable trusts unsuccessfully employs a common law judicial process to define the subject matter limits of the exemption. Other approaches employ a political process to make ad hoc, normative judgments of which activities deserve the exemption based on intensely empirical inquiries,<sup>19</sup> despite the absence of any political structure other than taxing agencies to make these judgments.<sup>20</sup> Only the donative theory employs a market-like process that relies on the self-interest of donors to choose for themselves the objects of charity that deserve public support. Donors "vote" for an indirect subsidy by participating in a "market in altruism" when they have been unsuccessful in obtaining direct provision through actual political or market mechanisms.

However attractive the donative theory is in broad outline, its acceptability turns on a host of minute inquiries such as precisely what acts constitute a donation, and exactly how the exemption should be administered. The donative theory still has not been subjected to the same detailed scrutiny that we have given the more conventional theories of the exemption. This unfinished task leaves a number of objections and imperfections to be addressed in the specific application and implementation of the donative theory. This Article undertakes this task by expanding on the donative theory in two dimensions: the theoretical and the practical. We develop more rigorously the theory for subsidizing donative institutions in order to repel attacks that it either goes too far or does

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<sup>19</sup> The community benefit theory requires taxing authorities to determine which activities are performed better in a nonprofit setting, and Hansmann's capital subsidy theory requires, in addition, a determination of which such activities suffer a disadvantage in obtaining capital financing.

<sup>20</sup> We do not mean that discrete political judgments *could* not or *should* not be made by political bodies with more appropriate authority over social policy, as legislatures sometimes do by extending ad hoc exemptions to encourage particular, favored activities. Our point instead is that this is not what *has* been done through the charitable deduction, as it has existed for over a century.

not go far enough, and we define more carefully how donative institutions should be identified and subsidized in order to understand how the exemption should be administered. Our aim here is to present a fully-articulated conception of the charitable exemption that is capable of immediate implementation.<sup>21</sup>

## II. THE THEORY OF SUBSIDIZING DONATIVE INSTITUTIONS

In this section we employ market theory, moral theory, and tax theory to achieve a deeper understanding of the rationale for subsidizing donative institutions. Our examination of market theory defines more precisely what constitutes a donation that signals an object deserving of social subsidy. We conclude that neither the particular market defect that leads to a donation nor the subjective motivation for a donation is relevant to whether the object of a donation qualifies for subsidy (at most, only to the *level* of subsidy); all that matters is whether a payment is in fact a donation, which is revealed by a *quid pro quo* test. We also conclude that no donation exists in a nonprofit organization's mere retention of its earnings.

Our examination of moral theory reveals that the foundation of the donative theory is not exclusively economic; it is strongly buttressed by the leading theories of distributive justice and by the pluralistic values that characterize the third sector. Finally, analysis of the deep structure of tax exemption reveals that the donative theory has a powerful explanatory force that provides a unifying rationale for all major aspects of the taxation of charitable institutions.

### A. Market Theory

The economic analysis supporting the donative theory is derived from the considerable progress that has been made over the past decade toward a positive theory of nonprofit enterprise. Scholars who have written about nonprofits have identified three idealized categories of nonprofit institutions, which are characterized by their sources of income: donative nonprofits, such as the Salvation Army, rely on contributions; commercial nonprofits, such as National Geographic, generate their receipts from sales; and mutual benefit organizations, such as a country club, derive revenue from dues-paying

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<sup>21</sup> Although the donative theory is novel in its articulation, its basis is fundamentally rooted in existing precedent. See Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 402. Because this theory derives from the existing structure and wording of the exemption, it is possible, although not likely, to implement the theory through administrative rather than legislative action. Cf. *Bob Jones Univ. v. United States*, 461 U.S. 574, 586 (1983) (IRS may by administrative ruling withdraw the exemption from racially discriminatory schools, even though this criterion is not stated in the statute, because it is implicit in the legal concept of charitable).

members. Only donative nonprofits deserve to be classified as "charitable,"<sup>22</sup> as is revealed through a closer examination of the reason for their existence.

### 1. *The Role of Donations in Economic Theory: The Paradigm Case*

Economists theorize that donative organizations exist to facilitate the production of certain "public goods," which can be either products or services.<sup>23</sup> Pure public goods in the economic sense are those characterized by two conditions: (1) *durability*—the cost of supplying everyone is no more than the cost of supplying a single person because the good does not wear out as others use it; and (2) *indivisibility*—the nature of the good is such that, once it is produced for one consumer, it is impossible to exclude its use by any other consumer. Classic examples of nearly pure public goods include air pollution control and border defense.

Under the strong public goods theory, the private market cannot be expected to supply pure public goods at any level, no matter how valuable they are, because no one has an incentive to pay his proportionate share of the benefit.<sup>24</sup> The weak version of the theory predicts that the market will undersupply public goods.<sup>25</sup> This market failure exists by virtue of the severe "free rider" incentive that affects public goods. Because such goods, once supplied, are available to all without regard to any individual's purchase, there

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<sup>22</sup> This does not mean that other forms of tax exemption may not apply to the other nonprofits. For instance, mutual benefit organizations are exempt from income tax, not as charities, but under the rationale that their pooling of members' dues does not constitute the generation of income, only the shared use of wealth already taxed. See *McGlotten v. Connally*, 338 F. Supp. 448, 458 (D.D.C. 1972). Similarly, the donative theory does not preclude exempting government entities, not as charities, but because it makes no sense for the government to tax itself and, reciprocally, one government should not tax another. As a possible extension of this theory, we observe in note 249 *infra* that it may be appropriate to exempt certain research organizations that rely heavily on government grants, even though they receive few donations.

<sup>23</sup> Leading discussions of this public goods theory of the existence of nonprofit enterprise include J. DOUGLAS, *WHY CHARITY: THE CASE FOR A THIRD SECTOR* 129-30, 145 (1983); B. WEISBROD, *THE NONPROFIT ECONOMY* 59-60 (1988) [hereinafter WEISBROD, *NONPROFIT ECONOMY*]; B. WEISBROD, *THE VOLUNTARY NONPROFIT SECTOR* (1977); Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1397-98 (1988); Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 848 (1980); Krashinsky, *Transaction Costs and a Theory of Nonprofit Organization*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY* 119-21 (S. Rose-Ackerman ed. 1986) [article hereinafter Krashinsky, *Transaction Costs*] [volume as a whole hereinafter *NONPROFIT INSTITUTIONS*].

<sup>24</sup> The classic statements of this theory are M. OLSON, *THE LOGIC OF COLLECTIVE ACTION* (1968) and Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243 (1968).

<sup>25</sup> Marwell & Ames, *Experiments on the Provision of Public Goods*, 84 AM. J. SOC. 1335, 1337-38 (1979).

is no incentive to pay for them if one supposes that someone else will pay. If one supposes others will *not* pay, there is still no incentive to purchase public goods at the optimal level because one who pays for such goods cannot charge others who benefit from them. "Regardless of how the individual estimates the behavior of others, he must always rationally choose the free-rider alternative."<sup>26</sup> The same thought is also captured in terms of extreme "positive externalities:" individual purchases will always fail to produce public goods at the optimal level since one who chooses to pay for such a good will realize only an infinitesimal fraction of the benefits that the good offers to society at large.<sup>27</sup> As a consequence of these severe free riding incentives and positive externalities, classic economic theory postulates that the government is in the best position to provide public goods (either directly, or by subsidizing private production) since government can coerce purchase by everyone via the power of taxation.

Sometimes, however, the government fails (for reasons discussed later)<sup>28</sup> to supply the optimal level of a public good. The consequence of this twin failure of markets and government is that people resort to voluntarism to provide unmet public needs. On first appearance, then, classic free rider theory is wrong since a considerable number of people are willing voluntarily to pick up litter or staff fire protection services, for example.<sup>29</sup> This arm-chair empiricism has been verified by more carefully controlled and rigorously designed social experiments, which demonstrate that free riding behavior is severely dampened by a set of motives loosely described as altruism—a willingness to take a collective view of social benefit and set aside narrow, individual self-interest.<sup>30</sup> Donative nonprofits exist as the preferred

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<sup>26</sup> J. BUCHANAN, *THE DEMAND AND SUPPLY OF PUBLIC GOODS* 88-89 (1968).

<sup>27</sup> See J. RAWLS, *A THEORY OF JUSTICE* 268 (1971).

<sup>28</sup> See *infra* text accompanying notes 124-27.

<sup>29</sup> Marwell, *Altruism and the Problem of Collective Action*, in *COOPERATION AND HELPING BEHAVIOR* 207, 224 (1982) [volume as a whole hereinafter *COOPERATION*] ("Any look at the real world demonstrates that the problem of collective action is frequently 'solved,' at least to the extent of permitting some collective goods, if not an optimal amount, to be provided. . . . In fact, voluntary collective action seems endemic.").

<sup>30</sup> Most of these studies are reviewed and critiqued in Isaac, Walker & Thomas, *Divergent Evidence on Free Riding: An Experimental Examination of Possible Explanations*, 43 *PUB. CHOICE* 113 (1984) and Kim & Walker, *The Free Rider Problem: Experimental Evidence*, 43 *PUB. CHOICE* 3 (1984). See also Caporael, Dawes, Orbell & van de Kragt, *Selfishness Examined: Cooperation in the Absence of Egoistic Incentives*, 12 *BEHAV. & BRAIN SCI.* 683 (1989) [hereinafter *Absence of Egoistic Incentives*], where the researchers gave groups of nine volunteers \$5 apiece and told them that if at least five members gave up their stakes, each of the nine would receive a \$10 bonus. The income maximizing strategy for each individual under these rules is to keep the money, hoping others will contribute, whereas the group strategy is to somehow designate five donors. *Id.* at 687. Under varying conditions (group discussion, no discussion) the rate of contributing ranged from 47% to

organizational form when an institutional setting is required for altruism.<sup>31</sup>

The observed willingness to donate conflicts with classic economics only in its most absolute form, though, by disproving the strong free rider hypothesis. That is, the willingness to donate conflicts with the classic economic theory that rational people will always choose to free ride. A more subdued version of the theory maintains only that individual purchases will produce less of a public good than is optimally desired. This weak free rider hypothesis is in fact validated by these empirical studies, each of which finds free riding to some degree, as predicted, just as common observation finds that voluntarism falls short of ideal aspirations.

The persistence of the free rider disinclination to support societal or group causes supplies the most rigorous justification for subsidizing the objects of altruism. The existence of a significant level of giving signals a collective benefit that the private market (and, as explained in Part II.B.1., the government) is incapable of supplying—which satisfies our criterion of worthiness. The free riding incentive tells us, however, that these donations

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84%, with the resulting voluntary provision of the "public good" (i.e., qualifying for the group bonus) ranging from 60% to 100%. *Id.* at 691. In a similar study, the researchers varied the constituencies of a dozen groups according to academic majors. Each of the groups showed some, but only a moderate, level of free riding behavior, except for the study group consisting of graduate students in economics, who free rode almost entirely. Marwell & Ames, *Economists Free Ride, Does Anyone Else?*, 15 J. PUB. ECON. 295 (1981).

There are various accounts of what motive overcomes free riding. In the language of sociology, the motive derives from a group dynamic or inbred sociality. *See Absence of Egoistic Incentives*, *supra* at 695–96. *See generally* DEVELOPMENT AND MAINTENANCE OF PROSOCIAL BEHAVIOR (1984) (collection of essays by sociologists). Psychologists tend to speak more in terms of a person's sense of elemental fairness, perhaps a product of the Superego. *See* H. MARGOLIS, SELFISHNESS, ALTRUISM, AND RATIONALITY 54–55 (1982). Economists postulate that some individuals' utility functions are dependent on the utilities of others. Alchian & Allen, *The Pure Economics of Giving*, in THE ECONOMICS OF CHARITY 5 (Inst. Econ. Affairs 1973) ("[T]he postulates of economic theory do not say that man is concerned only about himself. He can be concerned about other people's situations also."). *See generally* Sugden, *Reciprocity: The Supply of Public Goods Through Voluntary Contributions*, 94 ECON. J. 772 (1984) [hereinafter Sugden, *Reciprocity*]; Sugden, *On the Economics of Philanthropy*, 92 ECON. J. 341 (1982). And biologists theorize about an evolutionary basis for altruism, which enhances the odds of species survival. *See* S. BOORMAN & P. LEVITT, THE GENETICS OF ALTRUISM (1980); R. DAWKINS, THE SELFISH GENE (2d ed. 1989); I. E. STAUB, POSITIVE SOCIAL BEHAVIOR AND MORALITY 26–34 (1974) [hereinafter SOCIAL BEHAVIOR]; E. WILSON, SOCIOBIOLOGY: THE NEW SYNTHESIS (1975); Wilson, *Genetic Basis of Behavior Especially Altruism*, 31 AM. PSYCHOLOGIST 370 (1976). Further exploration of motive is contained below in Part II.A.3.

<sup>31</sup> Atkinson, *supra* note 5, at 587–96. Nonprofits are preferred by donors, as explained in more detail below, because they can be trusted better than for-profits to apply the donations faithfully to their intended purposes. *See infra* text accompanying notes 157–59.

systematically fall short of supplying the objects of philanthropy at an optimally desired level, that is, the level that would be supplied if the products or services were capable of being purchased (or did not suffer from government failure). A tax exemption for donative institutions helps to take up this donative slack by using the tax system as a form of shadow subsidy. This explanation also meshes perfectly with the rationale for allowing donors to deduct charitable contributions in computing their personal income taxes. The deduction encourages more giving, and the exemption helps the gift to go further.

## *2. Imperfections in the Paradigm: Generalizing the Public Goods Basis for Donations*

Although the characteristics of the paradigm case for subsidizing the public goods objects of donations are quite restrictive, the donative theory has the power to be generalized to all instances of donative behavior. This is necessary for the theory's survival since the paradigm case does not cover many (if any) real world situations. The classic objects of philanthropy are not pure public goods. Although education entails the public good of bolstering the economy with skilled workers and religion promotes moral values, both entail significant private goods: schools educate the children of donors and religion provides salvation (or at least spiritual guidance) to the faithful.<sup>32</sup> Even welfare relief, whose public good aspect is more pure (helping the poor assuages a societal conscience, a psychic benefit available to all), partakes only partially of public good characterization. At least an incidental motivating factor for donations to the poor is the localized distress that one person has in seeing another in a destitute condition. Relief of the *donor's* specific distress is not a benefit shared by the public at large.<sup>33</sup>

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<sup>32</sup> In the more economic terminology introduced at the outset, neither is completely durable: at some point, the church hall and the classroom fills and another must be built. Nor are they indivisible: admission could be charged (as it partially is by colleges).

<sup>33</sup> "When Thomas Hobbes was asked why he contributed to a beggar, and was this not due to Christ's commandment, he responded that he did so 'with the sole intent of relieving his own misery at the sight of the beggar.'" A. ETZIONI, *THE MORAL DIMENSION: TOWARD A NEW ECONOMICS* 51 (1988). Economist Milton Friedman echoed a similar sentiment in his *Capitalism and Freedom*: "I am distressed by the sight of poverty; I am benefitted by its alleviation . . ." M. FRIEDMAN, *CAPITALISM AND FREEDOM* 191 (1962). See also MacIntyre, *Egoism and Altruism*, in 1 *THE ENCYCLOPEDIA OF PHILOSOPHY* 462, 463 (P. Edwards ed. 1967) [article hereinafter MacIntyre, *Egoism and Altruism*]. Gergen incorrectly reasons that aid to the poor is an impure public good because the primary benefit is to the individual who receives the aid rather than to society. Gergen, *supra* note 23, at 1398. This is incorrect because the individuals who receive the aid do not purchase this good; therefore, the benefit to them is also an externality. It is simply more concentrated in them than in society at large. A good loses its public characteristic only to the extent that the

These imperfections present no obstacle to the justification for subsidizing donations, however. They merely demonstrate that donations support impure as well as pure public goods. "Strictly speaking, no good or service fits the extreme or polar definition in any genuinely descriptive sense. In real-world fiscal systems, those goods and services that are financed publicly always exhibit less than such pure publicness."<sup>34</sup> Indeed, if this were not so, the strong free rider hypothesis would be correct and we would see no donative support whatsoever. Thus, these impurities in the public good characteristic of the objects of philanthropy may be necessary in order for there to be any philanthropy.<sup>35</sup>

The public goods theory for subsidizing the objects of donations can be generalized even further than this to cover situations that cannot be characterized as public goods at all without straining the meaning of this term. This generalization comes from recognizing that the essential aspect of public goods that invites donative support is some form of market failure. Public goods dramatize a particular form of market failure—they present a polar case of free riding associated with positive externalities—but the same rationale exists for free rider defects in any of their manifestations or at any level of intensity.<sup>36</sup> Indeed, stated even more broadly, donations are a generic tool for overcoming any number of market defects regardless of their free riding characterization. Consequently, the essential fact in the donative theory is the existence of donations per se, not an a priori assessment of the nature of the market defect that produces the donation. Where there is significant donative behavior, there is a market defect that gives rise to the donation. The free riding associated with *giving*, not with the particular market defect that *produces* the giving, is the essential component of the rationale for subsidizing donative institutions.<sup>37</sup>

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consumer is willing (and able) to pay for it. Only then are the benefits internalized to the purchaser.

<sup>34</sup> J. BUCHANAN, *supra* note 26, at 49; *see also* Gergen, *supra* note 23, at 1398.

<sup>35</sup> On the other hand, these impurities may mean that those mixed objects of philanthropy that represent more private than public goods will, on account of that fact, receive proportionately fewer donations because they may suffer less market failure. The effect of public goods impurities on the level of giving depends on whether the private benefit can be obtained only through giving (as with religious salvation) or instead may be purchased (as with education).

<sup>36</sup> It should be kept in mind, though, that some forms of market failure do not produce donations, perhaps because they are self-correcting within the market, perhaps because they are corrected by government intervention, or perhaps because the contributing public views them as insignificant or less significant than other defects that do receive donations. The point, again, is that the focus ultimately is on the existence of the donation, not on theorized cases for some form of subsidy.

<sup>37</sup> James Buchanan pursues a similar analytical path in discussing public goods. He observes that the economic theory would quickly break down if it depended on the purity of the polar examples; consequently, he eschews any normative inquiry into which goods



Transaction-cost analysis helps explain that the classic incidents of pure public good status (indivisibility and durability) are not the sole economic determinants of donative activity.<sup>38</sup> Many services that are said to be public goods do not actually face an absolute indivisibility problem. Instead, it is merely difficult or uneconomical to assess each consumer's benefit and, therefore, charge him or her appropriately. For instance, when the government builds a road, it sometimes erects a toll booth to charge the particular drivers who use the road, suggesting that a private good is involved. It is not impossible to do this for every road, but in most circumstances this form of revenue collection is less efficient than simply taxing all residents. Thus, some goods become "public" at one price (or level of production) but not at another. Similarly, while it is technically feasible for churches and synagogues to charge admission,<sup>39</sup> such crass commercialism could be viewed as destroying the

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deserve government provision. Instead, he approaches the subject in a positivistic fashion observing which goods in fact receive government provision, and then examining the incidents of that provision. J. BUCHANAN, *supra* note 26, at 50 ("the [public goods] theory has a much wider base; . . . it retains general validity independently of the descriptive characteristics of particular goods and services"). We take the same approach to goods that receive donative support.

<sup>38</sup> J. DOUGLAS, *supra* note 23, at 37-38 (observing that "market failure," "public goods," "externalities," and "transaction costs" are flexible terms that provide alternative forms for expressing a range of similar ideas); *id.* at 50, 52 (transaction costs provide "another very fertile way of looking at the whole problem of market failure"; "unlike the dichotomous pair of 'public' versus 'private' goods, it emphasizes the graduated nature of the choice between supply through a commercial market, through voluntary action or through coercive government action"); Gergen, *supra* note 23, at 1397 ("To be public, a good need not be purely nonrival and nonexclusive. It is sufficient that the cost of excluding an individual is greater than the marginal cost of supplying the good to her as an additional user. It is then cheaper to supply the good freely than to charge each user for it."); Krashinsky, *Transaction Costs*, *supra* note 23, at 114 (advocating a transaction-cost analytical framework as providing a superior terminology for understanding nonprofits).

<sup>39</sup> Many in fact do so:

Many Jewish synagogues raise from twenty percent to all of their income through annual dues charged on a per family basis for membership in the local synagogue. For seats on High Holy Days there is often a separate charge that varies with the number and location of seats. Typical seat fees in 1982 ranged from \$200 to \$2000. Synagogues also often charge special fees to participate in Passover services and meals. Pew rental is another form of sales, one that has a mainstream Christian history in the United States. The payment of Mass stipends, fees fixed by the Catholic Church for Masses said in the name of or on behalf of the payor, also involves sale of services.

Note, *Religious Nonprofits and the Commercial Manner Test*, 99 YALE L.J. 1631, 1641-42 (1990). This account suggests that religion may receive fewer true donations than is commonly perceived. See *infra* text accompanying notes 96-97.

spiritual values enhanced by individual contribution. This loss of spiritual value is a transaction cost of treating religious services as a private good.<sup>40</sup>

Professor Hansmann provides another example in which the language of public goods does not illuminate the reasons for giving, yet a donative subsidy is deserving nevertheless. He observes that the public goods explanation does not easily fit philanthropic support of the performing arts because the primary benefit accrues to individuals in the audience rather than the community at large.<sup>41</sup> Nevertheless, significant philanthropy occurs.<sup>42</sup> Hansmann theorizes that the nonprofit performing arts rely on contributions to supplement ticket sales as a means of voluntary price discrimination by those who value the performance more than the average ticket holder.<sup>43</sup> Performance companies prefer this financing mechanism, despite the burden of soliciting contributions, because it helps to overcome a form of market failure that inheres in the fact that the marginal costs of admitting additional members into the audience (or of staging more performances of the work once it is rehearsed) is far below the average cost per ticket holder of producing the show.<sup>44</sup> But such a system of

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<sup>40</sup> Likewise, although government provision is often the first and more efficient alternative to the market failure associated with public goods, in some cases voluntary provision through donations may be preferred because coerced provision through taxation entails the transaction cost of destroying the enjoyment that comes from a sense of good citizenship. See generally Calabresi, *Comment* [on Arrow, *Gifts and Exchanges*], in *ALTRUISM, MORALITY, AND ECONOMIC THEORY* 58, 59 (E. Phelps ed. 1975) ("There is a whole category of goods or characteristics whose production cannot be bought or coerced and yet whose presence in the society gives individuals pleasure. These goods are often attitudes like trust, love and altruism whose value depends on their being freely given and which are therefore destroyed if they are bought or coerced.").

<sup>41</sup> Hansmann, *Nonprofit Enterprise in the Performing Arts*, 12 *BELL J. ECON.* 341 (1981). Symphony orchestras are recognized as providing some public benefit by enhancing a community's overall attractiveness to residents and newcomers, but Hansmann correctly argues that, much like a professional sports team, this benefit is incidental to the individual audience benefit.

<sup>42</sup> "The visual and performing arts received an estimated \$6.82 billion in 1988." AAFRC TRUST FOR PHILANTHROPY, *GIVING USA: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 1988* (1989), at 131.

<sup>43</sup> The performing arts find it difficult to justify charging widely different amounts for their tickets (perhaps the public outcry would be a transaction cost of doing so). Instead, via targeted fund raising, they extract higher payments from patrons who place the highest value on the arts.

<sup>44</sup> Assuming the ticket price is set so the marginal cost of enlarging the audience equals the marginal benefit to additional attendees, as competitive markets tend to do, then total revenues from ticket sales would be too low in many instances for the performance to be produced. The same point is more commonly illustrated by observing that, if an airline were to set a uniform price at the *marginal* rather than the *average* cost of boarding an additional passenger, it could never afford to take off the ground since marginal costs only compensate for an extra meal, a tiny increment of fuel, etc., not the already sunk costs of buying a plane, hiring a pilot, etc. The performing arts use donations as a mechanism to

voluntary price discrimination allows some patrons to take a free ride on the generosity of others. Therefore, a donative subsidy is needed to assist the scheme in reaching its optimal funding level.

A final example of the ability to generalize the public goods explanation for subsidizing the objects of donations comes from charitable contributions to public television and radio. Professor Gergen maintains that such contributions do not deserve personal income tax deduction because broadcasting is not an indivisible service (pay-per-view technology now exists, but was not available when radio and television began).<sup>45</sup> This misconceives the basis for a tax subsidy as depending too strictly on the purity of public goods characteristics. Despite the technical ability to charge for public broadcast services, the fact

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achieve the same result airlines achieve through discriminatory pricing schemes that tend to charge more to business travelers who place a higher value on flying than do recreational tourists who can fly for less by reserving much further in advance. This revenue scheme offers some advantage wherever there is a marked differential between average and marginal costs. *See* E. JAMES & S. ROSE-ACKERMAN, *THE NONPROFIT ENTERPRISE IN MARKET ECONOMICS* 28 (1986). Indeed, one way of describing public goods is those which have extreme economies of scale. This is precisely the "durability" component of the classic definition.

This observation, by harkening to the form of market failure typified by natural monopolies, suggests a further application of the generalized economic basis for donations. *See* J. DOUGLAS, *supra* note 23, at 35-41. Natural monopolies exist in those goods and services where competition is destructive because it tends to drive prices below a level that will sustain even a single producer. The paradigm natural monopoly is a product with large economies of scale, that is, one with large sunk costs of initial capital investment but low costs of additional production (in other words, one where the average costs far exceed the marginal costs). The result of the rapidly increasing returns from ever-expanding production is that a single firm can meet increased market demand more cheaply than can several competing producers. Competition thus becomes self-destructive: either it leads to an inefficient solution or, in more extreme cases, to a cyclical pattern that polarizes between monopoly pricing and rampant market entry. Such a paradigm is found in the classic public utilities (electric, gas, water and local telephone services), for which it is uneconomical to have several service lines running down each street. The traditional remedy is government intervention and protection, but Hansmann's analysis of giving to the performing arts illustrates that an alternative to government intervention is voluntary support of prices above those which market forces generate. The performing arts also illustrate that the incidents of extreme natural monopoly conditions—as with the characteristics of pure public goods—are not necessary for significant philanthropy to exist. Hospitals are another such enterprise. P. FELDSTEIN, *HEALTH CARE ECONOMICS* 212 (2d ed. 1982) (discussing natural monopoly characteristics of rural hospitals, but observing that in urban areas, there are only "slight economies of scale"); B. WEISBROD, *THE VOLUNTARY NONPROFIT SECTOR* 93-98 (1977) (describing hospital services that represent "investment indivisibilities," i.e., "facilities [that] come in sufficiently large and costly units that marginal cost pricing would likely mean unprofitable operations"). And hospitals historically received substantial donative support until the government displaced most of this financing. Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 400-03.

<sup>45</sup> Gergen, *supra* note 23, at 1443-44.

remains that, for whatever reason, those who devised the public broadcast system found it preferable to rely on donations rather than subscriber fees.<sup>46</sup> Because, as a consequence, we can anticipate that some free riding will occur, we know the service will be systematically underfunded, relative to the benefits donors and nondonors would be willing to pay for if the service were sold.<sup>47</sup>

The critical observation is that, because giving in any form is voluntary, potential donors can enjoy the organization's benefits for free. Otherwise, if the organization refused service to noncontributors, payments would not be donations at all; they would be purchases. The organization's decision to rely on gifts rather than sales is bound to create a free rider opportunity on which at least some significant number of people who benefit from the organization's services will capitalize. As a consequence, all donative organizations will be underfunded to some degree.

### 3. *The Irrelevance of the Motive for a Donation*

#### a. *The Cynical View of Altruism*

We have so far left it largely to intuitive assertion that significant free riding attaches to giving in all of its manifestations. This is not necessarily the case. If the free rider hypothesis is accepted, then one must ask why donations occur at all. The fact that they do means that some motive operates to overcome free riding, and, whatever this motive is, it could in theory be capable of correcting altogether the market defect that produces the need to give. We are (presently) incapable of resolving this apparent paradox at a level

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<sup>46</sup> The price discrimination rationale that Hansmann develops for the performing arts potentially explains why this is so, as does the natural monopoly explanation developed in note 44 *supra*, because the marginal costs of serving additional viewers is essentially zero. Also, the commercialization of these channels might be viewed as a transaction cost that would detract from the public spiritedness associated with PBS (although, here, the authors agree wholeheartedly with Gergen that the obnoxiousness of most PBS-affiliate fund raising campaigns imposes a far greater cost).

<sup>47</sup> To further illustrate, one could just as well argue that it is more logical for churches and synagogues to organize like social clubs and charge admission to those who attend services since the primary motive for filling the collection plate is the self-interested desire to have a place to congregate each week. *See supra* note 39 and accompanying text. Nevertheless, whether for ideological or practical reasons, churches and synagogues choose to rely primarily on voluntary contributions, which signals that some degree of free riding is present. Gergen argues that religions have a weak case for the charitable deduction because they "probably do not suffer greatly from freeriding, or at least do not suffer as much from freeriding as do most other charities." *Id.* at 1438. But this would only be a basis for providing *less* of a subsidy, or increasing the level of support required to justify a subsidy, not for denying the exemption altogether. *See infra* text accompanying notes 93-94.

of theory,<sup>48</sup> which seems to leave to empiricism the task of establishing a rigorous basis for deciding which objects of philanthropy to subsidize.<sup>49</sup> Fortunately, significant work by sociologists and psychologists that more closely examines the actual motives for giving<sup>50</sup> greatly eases this task by pointing a way towards clearly and predictably drawing the proper bounds of the donative theory.

Those who speak of altruism usually intend some moral assessment about the quality of motivation that prompts a gift, suggesting that it is made without reference to self interest. However, economic theorists have observed that, morals aside, giving is never truly altruistic because for giving to occur there must be some positive or negative incentive that operates selectively on the donor to induce the gift.<sup>51</sup> While this is undoubtedly true, it is tautologically so

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<sup>48</sup> See Sugden, *Reciprocity*, *supra* note 30, at 784 ("The economic analysis of non-selfish behaviour is still in its infancy: there is no unified theory that can explain all, or even most, of the observed regularities in such behaviour.").

<sup>49</sup> See Gergen, *supra* note 23, at 1396, 1444 ("the case for a deduction on efficiency or equity grounds turns . . . on empirical questions" such as what motivates giving and whether alternatives exist to obnoxious fundraising) (concluding that basis for subsidy is inconclusive for religion and weak for public television).

<sup>50</sup> In addition to the citations in the notes below, the following sources review various motivations for giving and other cooperative behavior, and they provide extensive citations to the theoretical and empirical literature: D. BAR-TAL, *PROSOCIAL BEHAVIOR* 39-50 (1976); N. EISENBERG, *ALTRUISTIC EMOTION, COGNITION & BEHAVIOR* 30-56 (1986); J. RUSHTON, *ALTRUISM, SOCIALIZATION & SOCIETY* 36-57 (1980); L. WISPE, *ALTRUISM, SYMPATHY & HELPING* 303 (1978); Amos, *Empirical Analysis of Motivations Underlying Individual Contributions to Charity*, 10 *ATLANTIC ECON. J.* 45 (1988); Gergen, *supra* note 23, at 1430; Karylowski, *Focus of Attention and Altruism: Endocentric and Exocentric Sources of Altruistic Behavior*, in *DEVELOPMENT AND MAINTENANCE OF PROSOCIAL BEHAVIOR* 139-40 (1984); Reykowski, *Motivation of Prosocial Behavior*, in *COOPERATION*, *supra* note 29, at 355-56. An excellent discussion and extensive bibliography are contained in M. HUNT, *THE COMPASSIONATE BEAST* (1990).

<sup>51</sup> *SOCIAL BEHAVIOR*, *supra* note 30, at 7 ("An actor may behave prosocially to gain material rewards for his act, to gain social approval and praise (or avoid social disapproval and even ostracism), . . . [to] feel good (gain self-reward) because he acted according to his values and principles (thus he maintains a positive self-concept) or when he expects empathic reinforcement (a reduction of the distress he felt as a result of vicariously experiencing another person's distress or an increase in his own positive feeling by vicariously experiencing the positive feelings of another that would result from his prosocial act)"); *id.* at 42-45 (canvassing reasons for prosocial behavior); Johnson, *The Charity Market: Theory and Practice*, in *THE ECONOMICS OF CHARITY* 94 (Inst. Econ. Affairs 1973) (same); Kenrick, *Selflessness Examined: Is Avoiding Tar and Feathers Nonegoistic?*, 12 *BEHAV. & BRAIN SCI.* 711, 712 (1989); Oliver, *Rewards and Punishments as Selective Incentives for Collective Action: Theoretical Investigations*, 85 *AM. J. SOC.* 1356, 1357 (1980) (a thoughtful examination of the way in which such incentives operate); Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 86 (W. Powell ed. 1987) [article hereinafter Simon, *Tax Treatment*] ("the donor enjoys memorialization, . . . hopes for

and therefore offers no insight into which motives are worthy ones and which ones are not.<sup>52</sup> But, this criticism accepted, the economist's challenge to the altruist is still troubling for it says that the mere presence of a gift does not reveal which set of motives is at play. Rejecting the strong egoistic premise that all gifts are selfish does nothing to validate that all gifts are altruistic, nor does it demonstrate which ones are which, or to what degree. As one court has summarized:

Community good will, the desire to avoid community bad will, public pressures of other kinds, tax avoidance, prestige, conscience-salving, a vindictive desire to prevent relatives from inheriting family wealth—these are only some of the motives which may lie close to the heart, or so-called heart, of one who gives to a charity.<sup>53</sup>

This cynical view of altruism creates two difficulties for the donative theory in justifying deservedness of a social subsidy. One difficulty derives from the source of the donative incentive, the other from its strength. If the incentive does not arise from the public benefit that the donative activity conveys, but rather is in the nature of a "side payment,"<sup>54</sup> the ability of donations to signal socially worthy objects is potentially destroyed because those who make the donation would be oblivious to the worthiness of the object served. Moreover, if the incentive is strong enough, it may undermine the need for an exemption because, if there is no free rider disinclination to give,

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salvation or at least the expectation of perpetual prayers, the shared benefits that come with public goods like parks or cleaner air, or the general expectation that somewhere, somehow, the giver will benefit").

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The proponents of [egoism] are always ready to . . . extend[] the concept of 'selfishness' to include any demonstrable source of motivation not previously subsumed under the concept. It seems advisable, therefore, to concede the [egoistic] dogma once and for all, thus rendering the hypothesis unfalsifiable and, therefore, sterile. Then one can go about the business of examining the rich variety of sources of human motivation governing choices where the outcomes of those choices result in the distribution of costs and benefits to self and others.

Rapoport, *Egoistic Incentive: A Hypothesis or an Ideological Tenet?*, 12 BEHAV. & BRAIN SCI. 719 (1989); accord A. ETZIONI, *supra* note 33, at 27-28; Harrison, *Egoism, Altruism, and Market Illusions: The Limits of Law and Economics*, 33 UCLA L. REV. 1309, 1311 (1986).

<sup>53</sup> Crosby Valve & Gage Co. v. Commissioner, 380 F.2d 146, 146-47 (1st Cir.), *cert. denied*, 389 U.S. 976 (1967).

<sup>54</sup> Marwell, *Altruism and the Problem of Collective Action*, in COOPERATION, *supra* note 29, at 221 (1982) ("For example, individuals who contribute to building a public museum are given public praise, or plaques are displayed as a payment in prestige or gratitude.").

donations may fund the good up to, or perhaps beyond, the socially optimal level.

Stated more succinctly, the cynical view of philanthropy maintains that donations result more from the self-interest of donors who desire to participate in a private benefit than from the public benefit their gift provides to others.<sup>55</sup> Therefore, the challenge is to determine whether certain payments are spurious donations, more in the nature of purchases than gifts. If so, our rationale for subsidy disintegrates because our theory holds that no subsidy is appropriate where private markets are functioning. If, however, the donative theory can be shown to survive even the most skeptical views of altruism, then we have great assurance that all objects of donations deserve some additional social subsidy. In the following sections, we will examine successively four categories of private benefit that potentially motivate donors:

(1) Direct, tangible benefits the donor receives from the supported services. For instance, Professor Gergen argues that viewers' gifts to public television are more in the nature of personal consumption than disinterested altruism.<sup>56</sup> Likewise, one might speculate that the primary motive for giving to religion is for the donor to provide himself a spiritual clubhouse.<sup>57</sup>

(2) Psychic benefits the donor receives merely from the act of giving itself, without regard to whether the gift does anyone any material good. Thus, one might repeatedly donate to famine relief in Ethiopia despite news accounts of rampant corruption in the manner in which this relief is distributed, because one feels good about even a futile attempt to do something about this human travesty, almost as a form of sacrificial offering accompanying a prayer.

(3) Purely selfish benefits the donor receives indirectly by giving. Thus, it is sometimes alleged that the primary motive for giving to education is the reputational benefit from naming a building or the selfish interest of enhancing the value of one's own degree, rather than the donor's disinterested recognition of the value of education to society.<sup>58</sup> Corporate giving is the best example of

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<sup>55</sup> See T. ODENDAHL, *CHARITY BEGINS AT HOME: GENEROSITY AND SELF-INTEREST AMONG THE PHILANTHROPIC ELITE* 25, 41 (1990); Bauman, Cialdini, & Kenrick, *Altruism as Hedonism: Helping and Self-Gratification as Equivalent Responses*, 40 J. PER. & SOC. PSYCHOLOGY 1039 (1981); Worchel, *The Darker Side of Giving*, in *DEVELOPMENT AND MAINTENANCE OF PROSOCIAL BEHAVIOR* 382 (1984).

<sup>56</sup> See *infra* text accompanying notes 65-74.

<sup>57</sup> Cf. Johnson, *The Charity Market: Theory and Practice*, in *THE ECONOMICS OF CHARITY* 92-93 (Inst. Econ. Affairs 1973) ("There is no free ride to heaven," or as Aldous Huxley once noted, "Charity is a peculiar species of fire insurance.").

<sup>58</sup> The second motive was suggested to us by a colleague, Ira Ellman. (We are not so cynical as to have thought of it ourselves.) See also Atkinson, *supra* note 5, at 541-42 ("Some donors no doubt glory in having their names attached, literally or otherwise, to

entirely self-interested motivation since it would be an abuse of the fiduciary obligation to shareholders for management to donate for any reason other than enhancing the corporate image.

(4) Benefits in the nature of an exchange, in which the motive for the gift is a material quid pro quo return to the donor. A nice example occurs in a recent Supreme Court case that considered whether fees paid to the Church of Scientology for spiritual "auditing" and training sessions were deductible charitable contributions.<sup>59</sup>

### b. *Donors Who Benefit Directly: Altruism Versus Egoism*

One cynical version of philanthropy distinguishes truly "altruistic" donations from those that are "egoistic,"<sup>60</sup> arguing that the latter do not deserve a subsidy because the donor partakes in the benefit he supports. At the extreme, some theorists maintain that all giving is, by nature, egoistic because it necessarily satisfies at least a desire to give.<sup>61</sup> Even under less tautological definitions of altruism, some researchers contend that most giving is prompted by the egoistic desire to benefit oneself, as by avoiding guilt or sadness, and not by the simple desire to benefit another as an end in itself.<sup>62</sup> The debate between altruism and egoism has occupied moral philosophers since the

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ivied walls; others certainly seek to bask in the reflected glory of their alma mater's faculty and future alumni.").

<sup>59</sup> *Hernandez v. Commissioner*, 490 U.S. 680, 688-89 (1989).

<sup>60</sup> Atkinson, *supra* note 5, at 526-32, who rejects this argument, describes this distinction in terms of "weak" versus "strong" altruism. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317, 322-24 (1977), develops this distinction in terms of gifts of "sympathy" and gifts of "commitment." See also Harrison, *supra* note 52.

<sup>61</sup> E.g., M. CHESTERMAN, *supra* note 10, at 311 ("It can in fact be argued that no charitable or philanthropic disposition can ever be purely and wholly altruistic. The donor or testator always expects some direct or indirect benefit in return, whether it be in the form of a material or a spiritual reward."); Kelman, *Personal Deductions Revisited*, 31 STAN. L. REV. 831, 880 (1979) ("charitable donors are the same as everyone else in an individualistic society: they use their money for their own relative benefit. Even the most sincere altruist buys the scarce resource of looking altruistic"). This view is said to have originated in 1651 from a discussion by Thomas Hobbes in *Leviathan*. There are two versions of this egoistic position: that no one is ever motivated by a concern for another as an end in itself, and that this motive is sometimes present but is outweighed by concern for one's own welfare. See generally MacIntyre, *Egoism and Altruism*, *supra* note 33, at 462-63; Milo, *Introduction*, in EGOISM AND ALTRUISM 3-11 (R. Milo ed. 1973) [volume as a whole hereinafter EGOISM].

<sup>62</sup> See, e.g., Cialdini, Schaller, Houlihan, Arps & Fultz, *Empathy-Based Helping: Is it Selflessly or Selfishly Motivated?*, 52 J. PERSONALITY & SOC. PSYCHOLOGY 749, 750 (1987) (presenting experimental results that indicate "that it is the egoistic desire to relieve sadness, rather than the selfless desire to relieve the sufferer, that motivates helping").



writings of Kant, so we hold no pretense of being able to resolve it here.<sup>63</sup> But resolving it is not necessary to the present inquiry because the judgment here is not a moral one; it is one of economics and social policy. The properly formulated question for present examination asks, putting aside labels and moral judgments, are donations still capable of signalling an activity that deserves a social subsidy despite the potentially private consumption nature of a donation?<sup>64</sup>

Professor Gergen's work provides an apt illustration of the confusion that unnecessarily confounds this inquiry. It is a misconception to distinguish between "altruism" and "egoism," as Gergen does, by supposing that a tax subsidy is not deserved when giving is motivated by the donor's desire to benefit personally from the supported service rather than to benefit someone else.<sup>65</sup> For instance, it is incorrect, or at least incomplete, to assert that those who contribute to public television do so because they enjoy watching it.<sup>66</sup> This is a *non sequitor*. Except for those stricken by severe guilt, viewers who donate are perfectly able to enjoy the service without paying, or, as the case with the present authors, to give less than they would pay if forced to subscribe.

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<sup>63</sup> See generally the 30 pages of commentary following *Absence of Egoistic Incentives*, *supra* note 30.

<sup>64</sup> It might be thought that this question could be answered empirically, simply by observing whether everyone who consumes the good in fact contributes to it. But, for some goods, such as psychic gratification from the betterment of society, it is impossible to make this determination. And, even if it were, there is no mechanism for determining whether those who contribute do so to the full level of their benefit.

<sup>65</sup> This criticism of Gergen holds, though, only if one views the exemption as a subsidy. As noted earlier, see *supra* note 7, the alternate view holds that the exemption is justified as part of the normative definition of the tax base. Under the tax base approach, it is possible to argue that the degree of self-abnegation is relevant to whether a donor should receive a deduction from income for a charitable contribution (as opposed to an exemption): the donation should be included if the donor receives personal satisfaction (and thus has "consumed" the donation), or on the contrary should be excluded if this consumption element is missing. See, e.g., M. GRAETZ, *FEDERAL INCOME TAXATION, PRINCIPLES AND POLICIES* 478 (1989); Bittker, *Charitable Contributions: Tax Deductions or Matching Grants*, 28 TAX L. REV. 37, 47 (1972). We will not end this debate here. We note, however, that the U.S. Treasury Department lists the charitable contribution deduction as a tax expenditure item in the annual budget, and hence from a political standpoint, at least, the deduction is viewed as a subsidy. See generally, S. SURREY & P. MCDANIEL, *supra* note 7, at 2-25 (general overview of the tax expenditure concept as implemented in the U.S. budget).

<sup>66</sup> Gergen, *supra* note 23, at 1443-44 (most giving to public television "is easily explained as the value donors place on the programming"); see also M. CHESTERMAN, *supra* note 10, at 408 ("only genuinely altruistic, redistributive and socially useful projects [should] be labelled charitable"; arguing that elite private schools, museums and the performing arts do not deserve the exemption).

Therefore, the desire to watch cannot, strictly speaking, be said to motivate the decision to give.<sup>67</sup>

More likely, viewers of public television give because of a sense of moral obligation that makes the act of giving itself satisfying. That they obtain this satisfaction from giving to a service they use themselves does not deprive the gift of its ability to signal either worthiness or neediness. Indeed, the fact that the donor has an interest in the service she supports verifies that the service has real benefit, and, if donations are widespread, the benefit is one shared by a significant portion of society at large.

Thus, a gift to cancer research motivated by the hope that the donor one day may benefit personally from a cancer cure cannot be discounted even if this motive is considered self-interested. The fact that the support occurs through a donation rather than a purchase means that a sacrifice was made.<sup>68</sup> Even under the cynical view of giving to schools and churches, the fact that enhancing the value of an educational degree is a benefit shared by many, as is the construction of a spiritual clubhouse, tells us that the donation identifies a service with a shared social benefit, however jaundiced or idealistic a spin we might place on the benefit.<sup>69</sup> At the same time the donor enhances his own welfare, he enhances the welfare of others similarly situated. This satisfaction of the worthiness criterion will be predictably true of all donations, regardless of the particular motive.<sup>70</sup> The fact that the organization relies on donations

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<sup>67</sup> Few people would believe that their individual gift makes a tangible difference in the actual quality or availability of the programming.

If Smith contributes \$25 to public television, no sensible observer will suppose that he does so expecting this will lead to \$25 worth of improvement in his private viewing of television, or indeed that his contribution will have any perceptible effect at all. Such behavior looks extremely puzzling in terms of a nontautological interpretation of self-interest.

H. MARGOLIS, *SELFISHNESS, ALTRUISM, AND RATIONALITY* 12 (1982).

<sup>68</sup> See Nagel, *Comment* [on Arrow, *Gifts and Exchanges*], in *ALTRUISM, MORALITY, AND ECONOMIC THEORY* 59 (E. Phelps ed. 1975). The moral objection that might be raised if the benefitted group is small and elite is considered below in Parts II.B. and III.B.2.d.

<sup>69</sup> One might reasonably object to the government subsidizing through a tax exemption a desire, however widely shared, to promote one's own educational degree. But this is simply a cynical spin that might be placed on any support for education. One could equally well argue that schools do nothing more than enable students to earn better paying jobs. A donative exemption for education is thus no less appropriate than government funding for schools.

<sup>70</sup> However, as mentioned *infra* at note 238, if a donation is made in contemplation of death, there may be a case for scrutinizing the degree of self-interest if one believes there is less self-sacrifice in disposing of wealth that the donor can no longer use personally, other than to give it to her family. In fact, the primary object of the law of charitable trusts is to

rather than sales signals that the good is one the nature of which benefits a number of people in a shared fashion. And the fact that the donor might have chosen to enjoy the same benefits by relying on the contributions of others tells us that contributions will be suppressed, at least somewhat, below the optimal level of desired shared benefits.<sup>71</sup>

The degree of self-abnegation in a gift is relevant, if at all,<sup>72</sup> only to the *amount* of subsidy that is deserved. A gift to an activity from which the donor derives no tangible benefits might be thought to suffer relatively more from the free rider inclination not to give. But it is doubtful whether it is worth the effort to fine-tune the system of donative support to the extent that Gergen attempts.<sup>73</sup>

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determine whether a trust benefits the public or instead whether a disqualifying private benefit is present. For instance, a trust to maintain the testator's grave (or that of his family) is invalid, whereas one to maintain an entire graveyard is enforceable. RESTATEMENT (SECOND) OF TRUSTS § 365 comment a (1958). Similarly, a trust to benefit employees of the founder's company is noncharitable because, like a gift to his family, it primarily is intended to enhance the founder's legacy. M. CHESTERMAN, *supra* note 10, at 313. These fine distinctions are not necessary for inter vivos gifts, especially if giving to a particular object is widespread.

<sup>71</sup> Again, optimality is defined as the hypothetical level the public would purchase or vote to support through taxes if market or government failure did not exist. Gergen observes though that, in certain circumstances, the private benefit is large enough in comparison to the external benefit to the public that voluntary action would not result in undersupport. Gergen, *supra* note 23, at 1410-12. For instance, we can expect no disinclination among adjacent property owners to call in a fire alarm because the benefit to the one who voluntarily calls greatly exceeds the minimal cost. But even if these extreme situations are classified as true donative acts (rather than quid pro quo exchanges), the very slight effort required means that they will receive very little valuation in the measurement of donative activity (in the example given, the value of the volunteer phone call would be 25 cents) and therefore will have an undiscernable effect on the availability of a subsidy.

<sup>72</sup> It can be argued from one perspective that egoism presents a stronger case for a donative subsidy than does altruism, considering that a donative subsidy requires a government as well as a market failure (as discussed in Part II.B.1., *infra*). The more localized benefit associated with egoistic giving is more likely to suffer from such government failure for the very reason that the benefit is less widely shared by voters at large.

Hospitals nicely illustrate this relationship between insularity and giving. They received a much greater portion of their revenues from donations at an earlier time in the century when they primarily served closely knit ethnic and religious groups whose members desired to assure for themselves a place to receive care that accommodated their particular practices and beliefs. As community hospitals began to assume a more homogenous quality and private insurance became more widespread, the basis for hospital giving became more purely altruistic, but it also diminished greatly in response to the government's increased funding. See Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 400-03.

<sup>73</sup> "You might buy a family television set not only because you enjoy it, or because you enjoy seeing your spouse enjoy it, but because your spouse enjoys your own enjoyment, and you enjoy the pleasure he or she receives in that indirect fashion. In other words, rewards tend to reverberate through an interdependent, altruistic system . . ."

Absent the ability to read minds, it is impossible to know with any precision the level of self-interest and free riding in personal motivations for giving. The donative theory can survive these adulterations of motive just as it accommodates the imperfections in the public goods rationale for giving.

The point of this analysis, simply put, is that the donor's participation in the benefits conferred by the charity does not, standing alone, disqualify the gift since all gifts partake of some form of self-interest. Otherwise, the gift would not have been made.<sup>74</sup> The quality of the motivation that the egoism/altruism distinction attempts to capture is a moral assessment, not an instrumental one that determines whether the donation signals a worthy and needy activity; therefore, this assessment is not relevant to the justification for a tax subsidy.

Still, the cynic maintains that some motivations are so crassly self-satisfying or so unrelated to the worthiness of the recipient as to deprive the

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Marwell, *Altruism and the Problem of Collective Action*, in *COOPERATION*, *supra* note 29, at 220; see also *SOCIAL BEHAVIOR*, *supra* note 30, at 9 ("there seldom are characteristics of the act that unequivocally indicate" the motive; "since altruistic intentions are socially valued, actors are motivated to present their intentions as altruistic, and thus their reports might not be reliable"); Simon, *Tax Treatment*, *supra* note 51, at 86 ("Ignoring motive may be a necessity for the tax system; the search for purity of charitable intention would be an unmanageable task, even ignoring the complications caused by psychoanalytic theory.").

This view has significant support in the decisions that wrestle with whether particular payments qualify for the charitable deduction. *Hernandez v. Commissioner*, 490 U.S. 680, 690 (1989) (the IRS "has customarily examined the external features of the transaction in question. This practice has the advantage of obviating the need for the IRS to conduct imprecise inquiries into the motivations of individual taxpayers. The lower courts have generally embraced this structural analysis.") (collecting citations); *Crosby Valve & Gage Co. v. Commissioner*, 380 F.2d 146, 146-47 (1st Cir.), *cert. denied*, 389 U.S. 976 (1967) ("Were the deductibility of a contribution . . . to depend on 'detached and disinterested generosity,' [language from the Commissioner v. Duberstein decision cited below] an important area of tax law would become a mare's nest of uncertainty woven of judicial value judgments irrelevant to eleemosynary reality.").

Justice Brennan might be thought to express a contrary view in his famous opinion in *Commissioner v. Duberstein*, 363 U.S. 278, 285-86 (1960), which maintains that the gift characterization for purposes of what counts as income turns on an assessment of "affection, respect, admiration, charity or the like impulses," an assessment that must be left to the "mainsprings of human experience." This opinion makes clear, however, that objective factors are important in measuring intent. *Id.* at 287 ("[T]here must be an objective inquiry as to whether what is called a gift amounts to it in reality"). See generally Sliskovich, *Charitable Contributions or Gifts: A Contemporaneous Look Back to the Future*, 57 U. MO. K.C. L. REV. 437, 470-87 (1989); Atkinson, *supra* note 5, at 530 n.92.

<sup>74</sup> *SOCIAL BEHAVIOR*, *supra* note 30, at 7 ("If behavior that demands various sacrifices is not reinforced in any way, it would extinguish over time. . . . When a person behaves prosocially out of altruistic intentions, purely to benefit another, he is still likely to have some anticipation of, and certainly the experience of, such reinforcement."); Broad, *Egoism as a Theory of Human Motives*, in *EGOISM*, *supra* note 61, at 97-98 (all giving is ultimately self-regarding in some sense).

gift of any ability to signal a deserving activity. These further attacks on the donative theory can be countered more effectively, however, by abandoning egoism/altruism and turning to a more useful distinction some theorists draw between the "act utility" and the "result utility" of voluntary activity.

### c. *Giving for Giving's Sake: Act Versus Result Utility*

A number of theorists have postulated two polar categories of motivation for a gift.<sup>75</sup> A gift satisfies a donor's "act utility function" if the donor desires to participate personally in addressing a social need. Such donors give perhaps to obtain a sense of righteousness,<sup>76</sup> perhaps to attach their names to the projects supported, perhaps to avoid social ostracism,<sup>77</sup> or perhaps to advance their careers. By contrast, charity satisfies a potential donor's "result utility function" if he desires only the social good that the charity produces. Act utility stresses means; the donor is satisfied by participation without regard to whether participation produces a beneficial end. In contrast, result utility stresses ends; satisfaction occurs by bettering some social condition regardless of the individual's actual participation in bringing about this result.<sup>78</sup> The act

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<sup>75</sup> This distinction is recognized and developed in a number of sources using varying terminology. The source from which we borrow this particular terminology is Ireland, *The Calculus of Philanthropy*, in *THE ECONOMICS OF CHARITY* 70-71 (Inst. Econ. Affairs 1973) [article hereinafter, Ireland, *The Calculus of Philanthropy*], which observes that act utility is sometimes called the "Kantian" motive. *Id.* at 67-68. The same distinction has been drawn in terms on "endocentric" versus "exocentric" motives for giving. Karylowski, *Two Types of Altruistic Behavior: Doing Good To Feel Good or To Make the Other Feel Good*, in *COOPERATION*, *supra* note 29, at 397. Recent economic theory has focused on "pure" versus "impure" altruism. *E.g.*, Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 *ECON. J.* 464 (1990) [hereinafter Andreoni, *Donations to Public Goods*]; Andreoni, *Giving With Impure Altruism: Applications to Charity and Ricardian Equivalence*, 97 *J. POL. ECON.* 1447 (1989); *see also* H. MARGOLIS, *supra* note 67, at 21; Arrow, *Gifts and Exchanges*, in *ALTRUISM, MORALITY, AND ECONOMIC THEORY* 13, 17-18 (E. Phelps ed. 1975); Calabresi, *Comment* [on Arrow, *Gifts and Exchanges*], *id.* at 58-59. For particularly helpful illustrations that give flesh and bones to this distinction by showing how it classifies specific motivations taken from real-world hypotheticals, *see* Karylowski *supra*, at 407, and Karylowski, *Focus of Attention and Altruism: Endocentric and Exocentric Sources of Altruistic Behavior*, in *DEVELOPMENT AND MAINTENANCE OF PROSOCIAL BEHAVIOR* 141-43 (1984).

<sup>76</sup> E. JAMES & S. ROSE-ACKERMAN, *THE NONPROFIT ENTERPRISE IN MARKET ECONOMICS* 25-26 (1986) (describing the "buying-in" mentality that allows donors to feel good about the charity's activities and claim them partially as their own).

<sup>77</sup> "An arts fund may reward contributors . . . by printing their names in a program. Workers ensure cooperation with a strike by threatening to ostracize or beat up strikebreakers." Oliver, *supra* note 51, at 1356.

<sup>78</sup> An everyday analogy might help to further clarify this distinction. Some people view shopping simply as a pleasurable activity in itself, a way to spend a rainy Sunday afternoon, even if they find nothing they want to buy, whereas others enjoy acquiring new

utility of a particular gift is individualized to the donor, whereas the result utility is shared broadly by other like-minded concerned citizens. The act/result distinction is similar to egoism/altruism<sup>79</sup> but is more revealing for our purposes because it directs our focus away from a primarily moral assessment of donative motive.

If pure act utility characterized a significant number of donations, the donative theory of the exemption would be seriously weakened.<sup>80</sup> If one gives to Ethiopian famine relief solely because the act of giving is gratifying and wholly without regard to whether the food ever reaches the starving population, then the donation meets neither the worthiness nor the neediness test. The existence of such a gift does not serve as a reliable indicator of public need; it is more in the nature of a sacrificial offering. Like a prayer, the only benefit it definitely provides is the donor's private psychic gratification. No free riding attaches to such pure act utility donations. The donor reaps all of the benefits of giving but does so only if he gives. Because the full benefit of this gratification is internalized to the donor, he can be expected to contribute up to the desired level, and because the benefit obtains only if the donor participates personally, an indirect tax subsidy to the recipient would not enhance this private benefit.

However, it is only in this hypothesized world of extreme act utility that the donative exemption would be a complete waste. It seems quite likely that virtually all gifts are motivated by a mix of act and result utilities.<sup>81</sup> Unless there were some form of act utility, the donor would have no reason to make the personal sacrifice of a gift. And, unless the object of the donation were at

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possessions but would prefer, if possible, to avoid the hassle of doing the shopping themselves.

<sup>79</sup> Egoism seems to align with act utility and altruism with result utility, but this is not necessarily the case. One could view as selfish an individual's purely abstract interest in the betterment of society because such a person has no interest in doing anything personally to help, or one could view as noble a person's desire to contribute to a charitable cause even if prodded by the value of name recognition.

<sup>80</sup> See Calabresi, *supra* note 75, at 59 (such giving entails no public good problem); Lee & McKenzie, *Second Thoughts on the Public-Good Justification for Government Poverty Programs*, 19 J. LEGAL STUD. 189, 194 (1990) (same). The theory would not be destroyed unless all donations fell at this polar extreme.

<sup>81</sup> Karylowski, *Two Types of Altruistic Behavior: Doing Good To Feel Good or To Make the Other Feel Good*, in COOPERATION, *supra* note 29, at 397-98; Steinberg, *Voluntary Donations and Public Expenditures in a Federalist System*, 77 AM. ECON. REV. 24 (1987). One telling method for determining the relative mix of act and result utility is the extent to which an increase in government expenditures on a public good "crowd out" private donations. If government spending crowds out at a 1:1 ratio, it is likely then that donors are concerned only with the result, not their personal participation. However, if increased government expenditures fail to displace *any* private giving, pure act utility is suggested. Empirical findings suggest that the crowd-out effect is somewhere between these two extremes. Kingma, *An Accurate Measurement of the Crowd-out Effect, Income Effect, and Price Effect for Charitable Contributions*, 97 J. POL. ECON. 1197 (1989).

least somewhat successful in achieving its desired ends, the donor would not likely derive any pleasure from personal participation, or at least would not continue to support the particular object in the future. In short, one can suppose that, all else being equal, those charities that do the most good will also produce the strongest act utility.

This mixture of personal satisfaction in helping, with an eye to the results that obtain, is precisely the condition that characterizes the paradigm case for the economic theory of the donative subsidy. Act utility can be thought of as the private good aspect of giving that motivates individual donors to reveal the existence of some unmet public need, whereas result utility can be thought of as the public good aspect of giving that maintains a free rider disinclination to meet the need at an optimal level.<sup>82</sup> For example, the personal gratification that comes from helping to address world hunger motivates donors to reveal their concern for world hunger; however, the generalized nature of the gratification that society receives in the more abstract knowledge that fewer people are starving is a benefit that is affected by free riding.

Still, it is a matter of psychological empiricism whether act utility fails to match result utility, that is, whether one's pleasure in participating is less than the actual social value in avoiding starvation (value as measured by hypothesized market or political spending decisions). In the cases examined earlier of support for public television and religion, the donor received directly the societal benefit supported. Because the donor's portion of the benefit in those cases is a small fraction of the whole, there is a predictable basis for concluding that the private benefit will induce a suboptimal level of support. Here, however, the private benefit is of a secondary nature: it is the donor's gratification in doing something to make others better off that induces a gift.<sup>83</sup> But it is not this private gratification that the exemption subsidizes (nor is it, in rigorous theory, the welfare of the primary recipients);<sup>84</sup> the exemption addresses society's shared concern over the welfare of the primary recipients. The difficulty is that there is no necessary relationship between the proxy and the primary object. Conceivably, the level of gratification that donors receive from gifts to pediatric oncology wards could (1) fall short of, (2) equal, or (3)

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<sup>82</sup> See Ireland, *The Calculus of Philanthropy*, *supra* note 75, at 70.

<sup>83</sup> The demarcation between these two cases is not as sharp in reality as we have drawn it here for purposes of illustration. We have already observed that, because the direct, tangible benefit to a viewer who supports public television is actually quite small, it is probably the psychic value of giving that serves as the prime motivation. Nevertheless, we use this as one analytical peg because of its contrast with instances of giving for which the motivation can *only* be psychic.

<sup>84</sup> Therefore, it is technically not on point to argue that the donor's empathetic experience of the recipient's suffering is likely to be less than the actuality of that suffering. The case for a donative subsidy turns on showing that donors contribute less than they and others empathize.

exceed the reality of how much society as a whole actually benefits from saving children from cancer.<sup>85</sup>

This is a troubling observation because it means that, although mixed act/result donations signal worthy causes, they do not necessarily signal needy causes: the level of donations may already be sufficient to meet the hypothesized societal optimum.<sup>86</sup> Nevertheless, there is some assurance in recognizing that the incentive to give has a self-correcting nature that *tends to* (but does not necessarily) weed out the possibility of excessive donations and depress them below the socially optimal level. We call this mechanism a market in altruism.

The market in altruism works as follows. Those donors who desire to make some personal contribution to the betterment of society will have many choices from which to satisfy this desire. They will naturally tend to choose the outlet that provides the most satisfaction. We can generally assume that, for most donors, this will be the worthy objects they perceive as needing the most support. However, as gifts combined with subsidies begin to approach the socially desired level (as measured through the perceptions of those inclined to give), gifts will begin to taper off. In stable social settings, these countervailing forces may settle at an equilibrium, but as social conditions change, this market in altruism redirects philanthropy and the accompanying tax subsidy to new objects. That some giving is uninformed, over-reactive, or otherwise might come from donors who are oblivious to social worth or need is troubling, but no more so than similar defects in the private or political markets. Moreover, the fact that a recipient must show a *substantial* level of donative support before qualifying for the charitable exemption means that minor aberrational patterns are usually screened out.

#### d. *Promotional Gifts: Self-Regarding Versus Other-Regarding Motives*

The prior section demonstrates that dividing the universe of donative motives between act and result utilities further reinforces the conclusion that motive does not matter. We still have not addressed, however, the most troubling case: where the motive to donate is entirely selfish. To clarify, we

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<sup>85</sup> See Ireland, *The Calculus of Philanthropy*, *supra* note 75, at 71 ("The amount of funds individuals seek to provide [for reasons of act utility] is not directly related to the amount they would seek to have in terms of the public goods motives. . . . This dichotomy leads to the paradox that individuals might voluntarily contribute for the provision of a public good in excess of the amount of the public good which would be justified by [result utility] efficiency conditions.").

<sup>86</sup> This is possible, even if some public good aspect exists, because the private benefit that donors derive merely from the act of giving conceivably is sufficient to exceed the desire by those who consume, but do not pay for, the social benefits. See Lee & McKenzie, *supra* note 80, at 194.



introduce a third distinction in donative motives: self-regarding versus other-regarding motives.<sup>87</sup> Both egoism and altruism, and both act utility and result utility, can be reconciled with the assumption that the motive to give springs from some regard for the welfare of another being, which regard forms the basis for the gift's signalling function. Some giving, however, can be shown to be entirely selfish in the sense that the donor's gratification is wholly driven by his own material well-being. This might be termed either a strong version of egoism<sup>88</sup> or an extreme form of act utility.<sup>89</sup>

To illustrate, a donor may give large sums to education solely as an act of crass self-promotion to obtain the community recognition that comes from naming a building or a professorship, caring nothing about the quality of education or even the values of gift-giving. This possibility does not rob gifts of their ability to signal worthiness for the simple reason that the social approval desired by the donor would not be forthcoming unless the object of the publicized gift were considered worthy by a broad segment of the public. Thus, even the most self-interested donation qualifies under our deservedness criterion if the private reputational benefit enjoyed by the donor serves as a proxy for social worthiness, in the same way that act utility serves as a proxy for result utility.<sup>90</sup>

The epitome of this category of purely self-interested giving is corporate philanthropy, which occurs primarily (if not solely) as a marketing strategy to enhance the corporation's image in the community.<sup>91</sup> "Few corporations engage in philanthropy because others need money, as though a corporation

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<sup>87</sup> This is suggested by the discussion in MacIntyre, *Egoism and Altruism*, *supra* note 33, at 463.

<sup>88</sup> See *supra* text accompanying notes 60–61.

<sup>89</sup> See *supra* text accompanying notes 75–86; Ireland, *The Calculus of Philanthropy*, *supra* note 75, at 74.

<sup>90</sup> See *supra* text accompanying notes 75–86. By way of analogy, it makes no difference if the present authors are motivated to write this article solely by the professional prestige that attaches to its publication in this fine journal, rather than by any consideration of the good this article might do for society or for the body of academic knowledge. If the prestige associated with this journal depends on the worth of its articles, our (hypothesized?) selfish motives serve as a proxy that motivates us to improve the quality of our work.

<sup>91</sup> See Galaskiewicz, *Corporate Contributions to Charity: Nothing More than a Marketing Strategy?*, in *PHILANTHROPIC GIVING: STUDIES IN VARIETIES AND GOALS* 246 (R. Magat ed. 1989); Useem, *Corporate Philanthropy*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 340, 348 (W. Powell ed. 1987) (containing extensive bibliography). To verify this, one study "found that the percentage of a utility's gross income contributed to nonprofit organizations is strongly correlated with the company's advertising and customer service expenditures, . . . [indicating] that charity is, in part, an extension of advertising and customer relations. . . . [I]ndustries with high levels of contact with the public, such as insurance, retail, and lodging, maintain significantly larger advertising and contributions programs than do mining, construction, primary metals, and other industries whose contact with the public is far more limited." *Id.*

were a well-heeled uncle who should spread his good fortune around the family. For the most part, corporations give because it serves their own interests—or appears to.”<sup>92</sup> Indeed, any other motive would be a breach of the corporate managers’ fiduciary duty to use corporate funds to benefit shareholders’ economic interests. This public relations strategy, however, is successful only to the extent that the objects supported by corporate philanthropy are perceived by the public as being worthwhile.

Still, a reputation-driven donor does not signal an object in need of a social subsidy if the rewards from public reputation are strong enough to induce the optimal amount of giving. As a matter of theory, there is no guarantee that slippage always exists; if it does not, there is, in effect, no free riding since the private rewards from giving (reputation enhancement) are enough to overcome fully the market defect that gave rise to the donation. Nevertheless, there is strong reason to suppose that pure selfish giving signals an object that needs subsidy. Again, this likely assurance is found in the concept of a market in altruism. One who gives for crass self-promotion will choose the object of giving that produces the most bang for the buck, all other factors being equal. This choice will likely be the worthy object among the donor’s range of choices that is perceived by the target population as being the most in need of support. It can be expected that, as the perceived need is more closely met, the reputational value of giving will fall off, shifting reputational value and attendant donors’ dollars to other, more recognized causes. This market in altruism creates some confidence (but not a guarantee) that the money of even the most selfish donors is not wasted on unneedy objects.

Only in rare instances will the motivation for giving be wholly divorced from an assessment of the object’s worthiness. One example is a gift prompted entirely by the nuisance value of avoiding harassing solicitation, with no thought to the cause being served. Consider, for instance, the harried traveler accosted in an airport by religious fanatics. The traveler might give some small change rather than pausing to consider how to extract himself politely. Although such a gift arguably supports a public benefit, this benefit plays absolutely no role in motivating the gift. Therefore, the gift serves no worthiness-signalling function. The donor might be entirely ambivalent, or even hostile, to the cause.<sup>93</sup>

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<sup>92</sup> Smith, *The Unsentimental Corporate Giver*, FORTUNE, Sept. 1981, at 121.

<sup>93</sup> Another application of this principle is found in *Ottawa Silica Co. v. United States*, 699 F.2d 1124 (Fed. Cir. 1983), which considered the deductibility of a property owner/developer’s donation of land for a new high school. The court found no qualifying gift because the IRS determined that the primary motive was that construction of the school would necessitate building access roads adjacent to the owner’s property, which would increase the value of his land. Because this benefit is unrelated to the value of the school, it does not serve as a valid proxy of the donation’s worthiness.

Undoubtedly, a nuisance element plays some role in giving. But unless an organization relies entirely on pure nuisance gifts, this simply becomes a partial impurity in the process, which might affect the *level* of tax support we should provide donative institutions, but which does not eliminate the case for exemption altogether. Even then, it is questionable whether it is worth the administrative costs of detecting this minor noise factor in the philanthropic sector.

This analysis demonstrates that, even in the extreme case of a pure act utility donor motivated entirely by selfish considerations of personal reputation, the object of the donation in all likelihood still deserves subsidy. This being true for the weakest imaginable case for social subsidy, we can be confident that donations generally deserve subsidy without engaging in close empirical examination of the precise motives behind individual acts or categories of philanthropy.

#### *e. Donors Who Receive a Quid Pro Quo: Gifts Versus Purchases*

Are there any situations, then, in which apparent donations fail to satisfy the requirements for subsidy? There are, but they may be considered cases of spurious donations in which it is proper to say that no gift exists at all; rather a purchase is made from the recipient. The test for such pseudo gifts is whether the gift is prompted by a quid pro quo, not merely an incentive.<sup>94</sup> By quid pro quo, we mean an exchange between the “donor” and the recipient in which the value of the return consideration is independent of the gift itself. Thus, what distinguishes a social club from a church is not a theoretical analysis of the presence of a public good, altruistic motive, or private benefit, but the simple fact that the club chooses to charge membership fees, excluding those who do not pay, whereas the church chooses to rely on donations, making its services available even to those who do not contribute.

The quid pro quo test is familiar to courts that have wrestled with gift characterization problems for purposes of the charitable deduction.<sup>95</sup> One who

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<sup>94</sup> Atkinson adopts this test in his extensive discussion of altruism: “What is distinct about my donors is not that they give without gain, but that any satisfaction they derive from giving is not in the form of a material quid pro quo for their donation.” Atkinson, *supra* note 5, at 526.

<sup>95</sup> The most oft-quoted test for what constitutes a “contribution” under § 170 of the Code is the “detached and disinterested generosity” language contained in the Supreme Court’s opinion in *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960) (to be a gift, transaction must proceed from a “detached and disinterested generosity” on the part of the taxpayer), a case that dealt with when an economic receipt constitutes a gift excluded from income under § 102 of the Code, rather than what constitutes a “contribution” under § 170. See B. BITTKER & L. LOKKEN, *FEDERAL INCOME TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 35.1.3, at 35–38 (1990); M. GRAETZ, *supra* note 65, at 482. Although this test implies an analysis of subjective intent, courts generally have looked to objective factors

pays for spiritual training sessions that are not delivered absent payment makes no donation,<sup>96</sup> nor does a developer who dedicates park land to the city in order to obtain zoning concessions.<sup>97</sup> The purchase of a ticket to the policeman's ball, however, does constitute a gift to the extent that the ticket price exceeds its market value.<sup>98</sup>

The participation enjoyment derived by an act utility donor might be characterized as a form of quid pro quo: the donor purchases psychic

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signifying motive when applying it to charitable contributions. *See supra* note 73, *Dockery v. Commissioner*, 37 T.C.M. 317, 321 (1978) (reviewing a number of alternative tests for charitable contributions, especially for contributions by business entities). *See generally* Sliskovich, *supra* note 73.

<sup>96</sup> *Hernandez v. Commissioner*, 490 U.S. 680, 690-91 (1989) (payments for spiritual "auditing" sessions conducted by the Church of Scientology do not constitute gifts; "[a]s the Tax Court found, these payments were part of a quintessential quid pro quo exchange: in return for their money, petitioners received an identifiable benefit, namely, auditing and training sessions . . . in each branch church. . . . Each of these practices reveals the inherently reciprocal nature of the exchange."). We would hold the same for churches and synagogues that charge for pews, membership or special services. *See supra* note 39. Naturally, this presents issues of line-drawing when the requirement of payment is not overt, yet strong pressure is exerted to make the payment. These lines, however, are nothing new. *See, e.g.*, Rev. Rul. 83-104, 1983-2 C.B. 46, in which the IRS recharacterized "donations" to private schools as tuition payments.

In contrast, an instance of truly sham religious donations occurred recently in California:

They say they are practicing the world's oldest religion. But police say their enterprise resembles the world's oldest profession. Such is the debate surrounding Will and Mary Ellen Tracy, a Canyon Country couple who have hit the national talk-show circuit to promote the unorthodox theology of the Church of the Most High Goddess, a "sex church" the Tracys operate in West Los Angeles. . . . Mary Ellen Tracy says she and other women act as priestesses who absolve the sins of male followers through sexual religious rites that predate Christianity. So far, she says, she has brought more than 2,000 male converts into the church. "Anything God wants from me, I will give him," said Tracy, 46. "If he wants me to be monogamous, I'll be monogamous. If he says go have sex with 20,000 men, I'll do it."

Last week, Los Angeles Police Department vice officers arrested the Tracys—Mary Ellen on suspicion of prostitution and Will on suspicion of pimping—citing the couple's request for donations to the church. . . . Will Tracy, 51, acknowledged the church followers must contribute money or services to participate in the rituals that involve sexual intercourse. But he said the contributions are religious sacrifices.

Padilla, *Is Church Old-Time Religion or Prostitution?*, L.A. Times, April 16, 1989, at 6, col. 1 (Metro section). The couple was ultimately convicted. L.A. Times, Sept. 9, 1989, at 10, col. 4 (Metro section).

<sup>97</sup> *Stubbs v. United States*, 428 F.2d 885 (9th Cir. 1970), *cert. denied*, 400 U.S. 1009 (1971); Sliskovich, *supra* note 73, at 460-70.

<sup>98</sup> Rev. Rul. 67-246, 1967-2 C.B. 104 (bifurcating charity ball ticket price into sales and contribution elements).

gratification in exchange for the gift. But this is a benefit integral to the act of giving. By analogy to the doctrine of consideration, it is not given *by the recipient*, and cannot be characterized as having been bargained for.<sup>99</sup> A closer case is presented by one who receives the opportunity to name an educational building in exchange for a large gift—a return benefit that, if it were bargained for, would likely be viewed as legal consideration.<sup>100</sup> However, because the reputational value associated with the naming opportunity flows from the very act of making the gift and serves as a proxy for the social worth of the recipient, the value is not independent of the gift itself and so we classify it as a true donation. With these prototypes in mind, the quid pro quo test should serve as a reliable guide for differentiating true purchases from the self-interest that might be said to attend any donation.

#### 4. *Summary: The Market in Altruism*

The paradigm case for subsidizing the objects of donations is the role of altruism in rectifying the market failure that afflicts public goods. This paradigm, however, covers few instances of actual giving. There are two imperfections: the objects of most gifts are not true public goods, and the motives for giving are not purely altruistic. The donative theory avoids these difficulties because of its great generalizeability: it applies to virtually any act of giving, regardless of the object or the motive. The existence of a significant level of giving identifies a product or service the production of which is desired but not available through private markets. And, due to the free rider disinclination to give, we know that donations systematically will fail to support the optimal level of production (as measured by production if there were no market or government failure).

The power of this theory is that we need not understand why orchestras solicit and baseball teams do not, why social clubs charge admission but churches do not, or what is altruism and what is egoism. Motive matters only for the limited purpose of separating donations from purchases, but this is best done by looking for objective manifestations of an exchange whose return value is unrelated to the mere making of the gift. Discussion in terms of egoism confuses self-interest, which is always present to some degree in every

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<sup>99</sup> See A. FARNSWORTH, *CONTRACTS* 41–49 (1982). As tax scholars have noted, nearly every charitable contribution is prompted by some inherent benefit that might be called a quid pro quo. B. BITTKER & L. LOKKEN, *supra* note 95, at ¶ 35.1.3; M. GRAETZ, *supra* note 65, at 482–87. For instance, surely one reason Texaco has sponsored the Metropolitan Opera broadcasts for over 50 years is the image-polishing publicity it receives. Nevertheless, case law establishes that such incidental benefits do not disqualify a payment from donation status. B. BITTKER & L. LOKKEN, *supra*, at ¶ 35.1.3 (collecting cases).

<sup>100</sup> *Allegheny College v. National Chautauqua County Bank*, 246 N.Y. 369, 159 N.E. 173 (1927).

transaction, with a quid pro quo, which indicates an act of pure private consumption.

This distinction is most easily seen in the case of donors who receive tangible benefits from the services they support. Their direct participation in the benefits makes their gifts stronger, not weaker, signals of social worth. Subtler forms of self-interest, such as the donor who receives only psychic benefits from giving, and crasser forms, such as the donor who cares only about the reputational value of giving, are more challenging, however, because the proxy relationship between the motive to give and social worth tends to weaken our confidence that donations necessarily reveal causes that are both socially valued and in need of additional support. Nevertheless, even these motivations can be rehabilitated by observing that a market in altruism operates to direct these gifts to those objects that society perceives as most deserving. Like other markets, this one will not operate flawlessly, but it should operate predictably enough so that we can avoid the need to engage in intensive empirical examination of the subjective reasons for giving.

### 5. *Retained Earnings as Donations*

The preceding discussion addresses objections that the donative theory goes too far. In reality, few such critics are likely to surface since our theory will be seen as a significant retraction of the existing scope of the charitable exemption. Nevertheless, answering these objections is essential to establishing the donative theory on a firm analytical foundation. But, of more immediate significance are objections that the donative theory does not go far enough.

Principally, it is possible to argue, following the comprehensive discussion of altruism recently published by Professor Atkinson,<sup>101</sup> that our application of the donative theory incorrectly excludes from its coverage some organizations that deserve subsidy even under the theory's own terms. We maintain that the only nonprofits that qualify for an exemption are those that receive a significant portion of their revenues from donations. Atkinson, however, argues that virtually *all* nonprofit organizations<sup>102</sup> should be exempt because implicit in their formation is an act of altruism that deserves a social subsidy: in choosing the nonprofit over the proprietary institutional form, the organizer is agreeing in advance to devote the entirety of her potential stream of earnings to the enterprise that the institution is established to further.<sup>103</sup> This donative act is

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<sup>101</sup> Atkinson, *supra* note 5, at 542–57, 616–20.

<sup>102</sup> The sole exception is for so-called mutual benefit organizations—social clubs, mutual insurance companies, and the like—which are nevertheless exempt under a different rationale. *See supra* note 22.

<sup>103</sup> “[T]he net revenues that otherwise would have been distributable to its founders are now committed to the purposes for which the organization was created. Thus, the founders’ initial contribution of their potential earnings has an on-going aspect; the

implicit in the formation decision by virtue of the core defining characteristic of nonprofit corporations: they are prohibited by law from distributing their earnings and so must retain them for use within the institution. Therefore, even if the organization receives no donations whatsoever but derives all of its income from sales in the commercial marketplace, Atkinson would still classify it as a donative ("altruistic") institution.<sup>104</sup>

This nonsuperficial argument for applying the otherwise restrictive donative theory, paradoxically, would greatly expand the charitable exemption beyond its present bounds. This argument, however, is based on a flawed view of what constitutes a donation, as can be seen by applying the principles just explicated. First, the company's yearly act of retaining its earnings is in no sense a form of corporate philanthropy for the very fact that this retention is compelled by law. This lack of choice in the matter means that a nonprofit organization's annual retention of earnings neither serves as a disinterested assessment of its own social worth in that year nor is it accompanied by a disincentive to "give"—the two qualities necessary for donations to deserve tax exempt support.

If the mere existence of nonprofit enterprise is to constitute donative activity, it is only by virtue of the initial organizational decision. However, there are at least two reasons to reject the initial organizational decision as a form of donation.<sup>105</sup> First, corporate organizers who forgo a stream of

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organization embodies their altruism." Atkinson, *supra* note 5, at 551; see Weisbrod, *Private Goods, Collective Goods: The Role of the Nonprofit Sector*, in *THE ECONOMICS OF NONPROPRIETARY ORGANIZATIONS* 151 (1980).

The result of this position—that all nonprofits should be exempt because they retain their earnings rather than distribute them to shareholders—is the same as the result under the argument we previously examined which we described as the "plow-back" variant of the community benefit theory. Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 383-84. There, however, the justification for exempting all nonprofits was different from the justification examined here.

<sup>104</sup> Atkinson offers as an example the Orton Ceramic Company, a trust founded by Mr. Orton at his death with instructions to continue his life's work researching and producing parts used in the ceramic firing process. Atkinson, *supra* note 5, at 545-46. One can speculate that Mr. Orton's desire to promote the craft of ceramics motivated him to make an enduring donation to this enterprise of all its future earnings. However, the argument for this entity's exempt status does not rest solely with the organizational decision to retain future earnings, for the formation of the trust itself entailed the making of an actual, substantial donation from Mr. Orton's estate. Ultimately, though, we would not find this company to be donative because, for reasons explained in the text accompanying notes 252-56, *infra*, we would require greater evidence of deservedness than simply one gift from a single donor.

<sup>105</sup> The analytical path we follow here is identical to that used by the Supreme Court in the analogous context of determining whether purchasers of insurance policies from the ABA could claim tax deductible contributions for allowing the ABA to keep the dividends that the insurance policies earned. *United States v. American Bar Found.*, 477 U.S. 105 (1986). The Court rejected the ABA's argument that the policyholders' decision to forego

potential profits give away something that they never had. This decision does not partake of the same level of self-sacrifice as one who pays hard-earned cash out of pocket. Second, for many nonprofit organizations there are several reasons to suppose that the organizational choice was strongly influenced by the organizers' own financial interests.

Professor Hansmann offers one such reason. He explains that nonprofit organizations exist in most of their manifestations<sup>106</sup> to correct certain "contract failures" (i.e., market defects) in the ability of consumers to monitor the quality of services they purchase from the organization. The constraint on distributing profits that attaches to nonprofit firms remedies the inability to monitor by removing managers' ability to divert firm funds to their own pockets—the major form of abuse.<sup>107</sup> The principal application of this trust theory is to donative nonprofits since the "patrons" of these companies have the least ability to monitor what happens to their payments. But Hansmann also applies the theory to commercial nonprofits, arguing that consumers prefer to patronize nonprofits for complex services whose quality is difficult to monitor.<sup>108</sup> Thus, some commercial entrepreneurs may choose the nonprofit

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dividends reflected their desire to further the ABA's public service mission. The Court reasoned that no donations occurred from year-to-year because the policyholders were bound by contract to forego the dividends, and that no donation occurred at the time policyholders signed up because there was no evidence they were motivated by generosity as opposed to the inconvenience of bargaining more aggressively with the Foundation. *Id.* at 113-14.

<sup>106</sup> Hansmann recognizes that there are exceptions to this theory, primarily for so-called mutual benefit organizations described in note 22 *supra*. Hansmann concludes that these organizations are peripheral to the nonprofit form because they more accurately represent a third and distinct form of organization—cooperative corporations. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PENN. L. REV. 497, 582-83 (1981). Ellman, however, sees mutual benefit organizations as central to the nonprofit form. Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999 (1982). This debate is not germane to our analysis since the exemption of mutual benefit nonprofits stands on separate footing from the subsidy theories that this article discusses. *See supra* note 22.

<sup>107</sup> Hansmann, *supra* note 106, at 506; *see also infra* text accompanying notes 156-59 (further elaboration of Hansmann's trust rationale).

<sup>108</sup> Several scholars, though, disagree with this assertion, noting that many complex services are not nonprofit and that those that are nonprofit are not uniquely difficult to evaluate. *See* J. DOUGLAS, *supra* note 23, at 100 ("Private medical practice, dentistry, the law, the learned professions generally, the supply of pharmaceutical drugs, electrical contracting, any number of building trade crafts, automobile and television repairs are all fields in which the for-profit form is dominant."); Ellman, *supra* note 106, at 1032-33 (parents routinely evaluate child care services); Krashinsky, *Transaction Costs*, *supra* note 23, at 121-22 (stressing the difference between the two types of monitoring problems); Yoder, *Economic Theories of For-Profit and Not-for-Profit Organizations*, in INSTITUTE OF MEDICINE, *FOR-PROFIT ENTERPRISE IN HEALTH CARE* 20 (B. Grey ed. 1986) (noting that for-profits have large share of child care and nursing home markets and no share of legal



form simply to attract more customers.<sup>109</sup> This organizational motive is fully justified on a quid pro quo basis and therefore signals no need for a subsidy. Since there is no systemic bar<sup>110</sup> to organizers' self-interested choice of an organizational form that maximizes its receipts, a subsidy is superfluous.<sup>111</sup>

Another welfare-maximizing explanation is that organizers choose the nonprofit form merely to obtain the exemption itself.<sup>112</sup> If the combined financial benefits of the property, sales and income tax exemptions, together

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services, personal computers, or used cars). For purposes of our argument, however, it is not necessary either that all complex services be nonprofit or that all commercial nonprofits entail complex services. Our argument stands as long as this explanation applies to some nonprofits.

<sup>109</sup> Atkinson's response to this possibility is that it is irrelevant since, regardless of the founder's motive, the institution's earnings are used to subsidize the purchases by its customers. Atkinson, *supra* note 5, at 553. This explanation seriously misunderstands the significance of a donation to eligibility for a tax subsidy. It is nice that retained earnings are so used, but the question is why such an operation deserves a further subsidy from taxpayers. The only possible basis is if the founder's decision is driven by a disinterested recognition of social need. Declaring motive irrelevant in this circumstance removes from the organizational decision its signalling function.

<sup>110</sup> True enough, barriers to entry and expansion may exist in particular areas of nonprofit activity. For instance, Hansmann explains why some commercial nonprofits may suffer from a comparative disadvantage in accessing capital markets. Hansmann, *Exempting Nonprofit Organizations*, *supra* note 5, at 84. But these and other conceivable barriers do not apply to all nonprofits. Therefore, they do not provide a convincing reason to link tax exemption to nonprofit status generally. See generally Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 387-89 (critique of Hansmann's capital subsidy theory).

<sup>111</sup> This analysis is nicely illustrated by the several explanations for the predominance of nonprofit hospitals. Nonprofit enterprise is thought by many to proliferate in the hospital industry because doctors find it more attractive. There are varying accounts, different in their positive and negative emphases, on why doctors have this preference. See *supra* Hall & Colombo, *Nonprofit Hospitals*, note 6, at 367-74. However, they all share the premise that hospital organizers choose the nonprofit form to attract the most doctors, which maximizes the flow of patients.

<sup>112</sup> Witness the periodic news reports of "self-declared religious leaders whose faith emerges only at tax time." Ellman, *Driven from the Tribunal: Judicial Resolution of Internal Church Disputes*, 69 MICH. L. REV. 1378, 1442 (1981). For instance, 88% of the residents of Hardenburgh, New York once became ordained ministers of the "Universal Life Church" in order to turn their homes into temples and thereby claim a tax exemption. *Id.* at 1442 n.182.

Presently, the only way taxing authorities have to police such abuse of the exemption is for the government to determine whether the organization constitutes a "genuine" religion, yet "such external definitions are notoriously difficult to frame or administer; one is always on the edge of constitutional catastrophe." *Id.* at 1442-43; see Slye, *Rendering Unto Caesar: Defining "Religion" for Purpose of Administering Religion-Based Tax Exemptions*, 6 HARV. J. L. & PUB. POL. 219 (1983). The donative theory skirts this danger by using actual donations as an objective guide to the public's assessment of the genuineness of the organization.

with reduced postal rates, access to tax-exempt bond financing, and other economic advantages, are greater than the enterprise's expected earnings, then the trade-off of profits for exemption is nothing more than a purchase of an exemption. In labor-intensive service businesses, for example, the business organizers often pay out most, if not all of the potential profit in the form of salaries to employees and owners.<sup>113</sup> If the exemption helps avoid an entity-level tax,<sup>114</sup> more money is left to distribute as salary or to pay for workplace amenities. The consequence of applying the donative theory in this scenario would be an entirely self-justifying, viciously circular application of the exemption that would rob it of any test for deservedness: the exemption would go to whatever organization chooses the nonprofit form for purposes of obtaining the exemption—in other words, to whomever wanted it.<sup>115</sup>

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<sup>113</sup> Atkinson, *supra* note 5, at 544–45.

<sup>114</sup> Observe, though, that such enterprises can be organized in a manner that avoids an entity-level *income* tax. For instance, because the 1986 Tax Reform Act put corporate tax rates below personal rates and repealed the *General Utilities* doctrine that had permitted corporate owners to pay a single capital gains tax on corporate income upon sale or liquidation of the corporation, conventional tax advice for service businesses has been to organize as a partnership or Subchapter S corporation to avoid the double level of tax inherent in the regular corporate structure. See Freeman, *Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986*, 64 TAXES 962 (December 1986); Gonyo, *Tax Planning Opportunities Using S Corporations Under the Tax Reform Act of 1986*, 65 TAXES 552 (August 1987). These alternative structures, however, have their own limitations: partnerships require at least one person with unlimited liability, while Subchapter S limits the number and kind of investors. See I.R.C. § 1361 (West Supp. 1991); W. MCKEE, W. NELSON & N. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 3.06 (2d ed. 1990). Moreover, neither avoids a property tax. Therefore, one can easily conceive of situations in which a regular corporation with a tax exemption remains the most attractive form.

<sup>115</sup> Nevertheless, one can attempt to rehabilitate the argument for exempting commercial nonprofits under the donative theory by observing that a valid social signalling function occurs in the decision of customers to patronize a nonprofit over a competing for-profit facility. Some people may choose to give their business to the nonprofit simply because they approve of the nonprofit's activities. For instance, in *United States v. American Bar Endowment*, 477 U.S. 105 (1986), the Supreme Court considered whether ABA members make deductible contributions when they purchase ABA Endowment-sponsored insurance policies. The Court held no; the policies were competitively priced and therefore the members received a full, quid pro quo exchange. Nevertheless, one could argue that the members' decision to shop with the ABA operates as a quasi-donation because it signals their approval of ABA activities.

However, the problems under this variant argument for crediting retained earnings as donations are the same as under the main line. We have no easy way to determine whether customers make their shopping decisions based solely on self-interest (perhaps because of Hansmann's trust rationale for preferring commercial nonprofits) or from a sense of public spiritedness. Even if we assume some level of eleemosynary intent, we face the difficulty of measuring the significance of this intent. Actual donations, and even the main line of the retained-earnings argument, offer us some basis for hard quantification of the size of public

Still, it is possible that a significant number of nonprofit formations are altruistic to some degree. The difficulty is that, as noted above, there is no objective method to test for the accuracy of assertions about the founders' subjective motives.<sup>116</sup> But the fact that significant numbers of nonprofits do not deserve the exemption counsels that, if only for prophylactic reasons, the organizational decision should not be counted as a donation.<sup>117</sup>

An additional factor puts the case to rest. Even for worthy organizational motives, crediting the organizational decision as a once-and-for-all donation would have the result of forever exempting the organization's stream of income, no matter how it fits into the changing social milieu. This is proper only if we are convinced that the organizer's initial decision operates as a continuing signal of social need, but at some point down the road this initial decision loses its social significance as it becomes more distant from the contemporaneous scene. In effect, these organizations are removed from the marketplace in altruism, which serves as a barometer of present social needs and preferences. Therefore, the same policies against dead-hand rule that prohibit various restraints on alienation also counsel against forever exempting all nonprofits at the outset of their corporate lives.<sup>118</sup>

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support, but this variant argument leaves us to pure speculation. (It is incorrect, under this variant argument, to measure the value of the retained earnings generated by sympathetic sales. Nonprofit customers do not donate the profit portion of the sales since they would have had to pay this portion in any event as a cost of for-profit capital. Therefore, it is inseparable from the manufacturing cost of the products they purchase.)

<sup>116</sup> See *supra* text accompanying notes 87-93.

<sup>117</sup> Throughout this section we refer strictly to the decision to organize, not to any actual donations of start-up capital that are made at the organizational stage. These present out-of-pocket contributions do qualify as donations.

<sup>118</sup> Perhaps the one arena in which the retained earnings argument potentially merits acceptance is for commercial organizations that serve a redistributive function. A charity that uses a large portion of its retained earnings to support free services to the poor can safely be assumed to be pursuing a worthy purpose because helping the indigent is the quintessential charitable activity, one that has enjoyed *per se* charitable status for over four centuries. This status is not likely to change soon. Therefore, it is safe to assume that founders who choose a nonprofit form in order to serve the poor act from public spiritedness and that their decisions have continuing social validity into the future. Only by this convoluted route is the donative theory arguably capable of covering a nonprofit entity that serves the poor, yet receives no overt donative support.

However, accepting this argument creates several difficulties. First, one must be able to draw the boundaries of this special category of cases. Precisely who are the poor, and how much aid must go to them in order to qualify? These are the type of *ad hoc*, normative decisions that revenue agents make in the present, unhappy state of affairs which the donative theory seeks to avoid. Second, assuming a valid case of deservedness can be established, the resulting subsidy suffers under the proportionality criterion since, without the presence of donations to measure the extent of the entity's beneficence, there is no mechanism for adjusting the level of subsidy to the level of deservedness. Thus, a very large commercial nonprofit enterprise that happens to generate very little income might

## B. Moral Theory

### 1. Ethical Objections to an Implicit Tax Subsidy

In the view of some, the style of reasoning we have employed so far is antithetical to its subject since altruism operates on a plane of human experience that is removed from baser considerations of economic efficiency and analytical logic.<sup>119</sup> This section responds to this attitude by demonstrating that the charitable tax exemption also gathers strong support from moral theory, support that depends on the donative status of exempt organizations. This support is all the more impressive because it comes from each of the two leading schools of liberal moral theory: contractarian and libertarian. The tenets of these theories of distributive justice are set forth in two modern masterpieces—John Rawls' *A Theory of Justice* (1971) and Robert Nozick's *Anarchy, State and Utopia* (1974)—that promise to frame the parameters of moral and political debate well into the twenty-first century.<sup>120</sup>

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enjoy tremendous property tax relief simply by giving away all of its earnings. Finally, one must ask, if such an organization is really deserving, why is it not able to structure its operations in a manner that would qualify under the main line of the donative theory? The lack of donative support suggests that we may be too generous in assuming its worthiness or neediness. As one court has explained:

The rationale behind requiring an institution [to] be maintained by public or private charity goes to the essence of tax exempt status: The expense of the [free] services must be defrayed by donations . . . to the institution, rather than the costs being borne by paying customers. Big business does the latter—it passes its expenses onto its customers; charity does not or should not.

School Dist. v. Hamot Medical Center, No. 138-A-1989 (C.P. Erie Cty., Pa., May 18, 1990), at 35.

Thus, if tax law is to continue to exempt entities that serve the poor but that receive insubstantial donations, it should do so on some basis other than the donative theory, such as the theory that these entities relieve the government from a burden it would otherwise have to undertake. But such a theory would encounter the difficulties summarized in our prior article, Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 354-63.

<sup>119</sup> Cf. Atkinson, *supra* note 5, at 630 (In deciding on the scope of the charitable exemption, "[w]e come, directly or indirectly, to a basic question: What is ultimately good? . . . I must admit my suspicion that the question of inherent goodness may not be subject to proof, in the case of either altruism or other proposed desiderata. . . . [The case for subsidizing altruism] is not a matter of logical proof, but of faith, of freely chosen values and visions.").

<sup>120</sup> See Murphy, *Rights and Borderline Cases*, 19 ARIZ. L. REV. 228, 228 (1977) (These two competing theories of justice "are currently dominating discussion within contemporary Anglo-American moral, social, political, and legal philosophy."); C. KUKATHAS & P. PETTIT, *A THEORY OF JUSTICE AND ITS CRITICS* (1990) (discussing impact of, and contrast between, the two works); J. PAUL, *READING NOZICK* 1-2 (1981)

Rawls draws from the "social compact" theories of Locke and Rousseau to posit that those principles of justice should control by which every rational, self-interested person would agree in advance to be bound, under certain idealized conditions that Rawls describes as the "original position."<sup>121</sup> For instance, Rawls argues that anyone in the original position, not knowing his actual status in society, would, following a "maximin" strategy, adopt a principle that requires society to distribute its resources to the advantage of the least well off individuals.<sup>122</sup> In sharp disagreement, Nozick maintains that Rawls' original position is a loaded theoretical construct designed to produce a set of redistributive principles in conflict with the preeminent moral principle: that the state must "treat[ ] us as inviolate individuals, who may not be used in certain ways by others as means or tools or instruments or resources, [and must treat] us as persons having individual rights with the dignity this constitutes."<sup>123</sup> Remarkably, a charitable tax exemption derived from the donative theory fits squarely within both of these competing theories of distributive justice. Indeed, the donative theory of the exemption provides what might be considered a paradigm case for each school of moral thought. But in order to realize this easy fit with moral theory, it is necessary first to explain in more detail the government failure component of the donative theory.

The case for a donative subsidy is marked by the twin failures of private markets and the government to supply a desired product or service. Economists ordinarily conceive of government taxation as the best means to overcome the market defects that attend public goods.<sup>124</sup> Public choice theory, however, informs us that governments can also fail to supply these goods at an optimal level.<sup>125</sup> This is most easily seen in the case of goods for which the public's desire varies widely.<sup>126</sup> For such goods, voting support falls off as the cost of

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(same); T. POGGE, *REALIZING RAWLS* 15-16 (1989) (same); *see also* R. NOZICK, *ANARCHY, STATE AND UTOPIA* 183 (1974): "*A Theory of Justice* is a powerful, deep, subtle, wide-ranging, systematic work in political and moral philosophy which has not seen its like since the writings of John Stuart Mill, if then. It is a fountain of illuminating ideas, integrated together into a lovely whole. Political philosophers now must either work within Rawls' theory or explain why not." *See generally* J. STERBA, *JUSTICE: ALTERNATIVE POLITICAL PERSPECTIVES* 2-12 (1980) (outlining modern theories of justice); Griffin, *Reconstructing Rawls' Theory of Justice: Developing a Public Values Philosophy of the Constitution*, 62 N.Y.U. L. Rev. 715 (1987) (discussing relevance to legal thought).

<sup>121</sup> J. RAWLS, *supra* note 27, at 11-12.

<sup>122</sup> *Id.* at 83, 153.

<sup>123</sup> R. NOZICK, *supra* note 120, at 333-34; *see also id.* at 149-55, 198-204 (responding to Rawls).

<sup>124</sup> *See supra* Part II.A.1.

<sup>125</sup> We develop this explanation somewhat more fully in Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 392-94. The principal source of this theory is B. WEISBROD, *THE VOLUNTARY NONPROFIT SECTOR* (1977).

<sup>126</sup> However, this is not the only explanation for government failure. As with market failure, Part II.A.2., *supra*, the precise cause of government failure, whether voting logic or

production (and therefore the level of taxation) exceeds the majority of voters' desire for the good. As a rough approximation, then, public goods are supplied only to the level desired by the median voter.<sup>127</sup> The consequence for high-demanding (supramedian) voters is that the only option available is voluntary support, which is suppressed by free riding. Therefore, their demand for the public good can be fully met only through an additional, implicit subsidy (a direct subsidy having, by definition, failed).

This account leads, however, to the possible objection, as described by Professor Hansmann, that the exemption unfairly raises the taxes of the majority to benefit a small and possibly elite minority:

[The Metropolitan Opera] is a public good only to individuals who actually attend performances, . . . a small and exceptionally wealthy subset of the general population. Should working people in Peoria pay higher taxes to subsidize the consumption of such conspicuously expensive entertainment by the rich in New York?<sup>128</sup>

If the majority of voters have rejected an explicit subsidy, how can it be legitimate to systematically impose an implicit subsidy? Moreover, a system that allocates governmental support according to the degree of private donative

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these other possibilities, is not crucial to the conclusions we draw. Thus, dissatisfied voters may simply decide as a matter of transaction costs that it is easier to encourage contributions than to solicit the government, Krashinsky, *Transactions Costs*, *supra* note 23, at 125, or voters may conclude that production through government coercion diminishes the value of production that obtains from the mere existence of voluntarism. See Calabresi, *supra* note 75, at 59-60 (citing as examples "goods [which are] attitudes like trust, love and altruism whose value depends on their being freely given and which are therefore destroyed if they are bought or coerced"). In developing the latter point, theoretical economists have demonstrated that *direct* government provision of public goods may actually decrease overall societal welfare by depriving donors of the opportunity to give themselves, which they value to the extent that giving is motivated by act utility. Andreoni, *Donations to Public Goods*, *supra* note 75, at 470; Lee & McKenzie, *supra* note 80, at 198. Therefore, an indirect government subsidy that matches or amplifies the effect of private donations, as the charitable exemption does, is a superior form of government provision. Andreoni, *Donations to Public Goods*, *supra* note 75, at 471.

<sup>127</sup> See J. BUCHANAN & G. TULLOCK, *THE CALCULUS OF CONSENT* 136 (1962).

<sup>128</sup> H. Hansmann, "Trouble Spots" in the Law Affecting Nonprofit Organizations 8-9 (Sept. 1989) (unpublished paper presented at "Research Agenda—Legal Issues Affecting Nonprofit Organizations," New York University, Nov. 10, 1989); see also T. ODENDAHL, *supra* note 55, at 3 ("wealthy philanthropists divert decision making in [the nonprofit sector] from public representatives to a private power elite"). Gergen makes the same point in the more technical jargon that tax support for charities whose benefits are widely shared meets Pareto-optimal criteria for efficiency since it leaves no one worse off, but that tax support for more localized or unique benefits is only Kaldor-Hicks efficient since it tends to leave worse off those taxpayers who do not share in the benefit, or, indeed, who might affirmatively oppose the charity's service. Gergen, *supra* note 23, at 1412-13.

support gives more weight to the needs and tastes of those with the greatest financial ability to give. Thus, several commentators have observed that a donative subsidy "has a decidedly elitist caste to it."<sup>129</sup>

## 2. Rawls' Contractarian Theory of Justice

A Rawlsian analysis directly responds to these objections. The donative theory serves as a model for Rawlsian justice because the government failure component of the theory so nicely exemplifies the effect of imposing the "veil of ignorance"—the principal condition that characterizes the original position—from which the terms of the idealized social contract are generated. The core of Rawls' unique insight<sup>130</sup> is that principles of justice derived by hypothesized societal consensus must be blind to the contracting parties' knowledge of their particular circumstances in life in order to remove any individual bias toward designing principles to favor one's own condition. Among the essential features of this original position are that no one knows "his place in society, his class position or social status, nor does any one know his fortune in the distribution of natural assets and abilities, his intelligence, strength, and the like. I shall even assume that the parties do not know their conceptions of the good or their special psychological propensities."<sup>131</sup> Applying this analytical framework to particular laws, one legal scholar explains that we

should ask whether the challenged legislation could reasonably have been adopted by community members if no one in the community knew, at the time the law was adopted, whether they would be in the advantaged or

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<sup>129</sup> McDaniel, *An Alternative to the Federal Income Tax Deduction in Support of Private Philanthropy*, in TAX INSTITUTE OF AMERICA, *TAX IMPACTS ON PHILANTHROPY* 87 (1982); see also Simon, *Charity and Dynasty Under the Federal Tax System*, in NONPROFIT INSTITUTIONS, *supra* note 23, at 246. Observe that these objections have been made to the charitable *deduction*, which, due to the bracketed nature of individual income taxation, has a far greater regressive effect. (Although the corporate tax rate varies some among entities, this variation does not create an equity problem since it occurs irrespective of the wealth of donors.) Thus, the "flat-tax" effect that these commentators argue should be given to charitable donations by replacing the deduction with a tax credit, already exists for the charitable exemption, which (with certain exceptions noted in Part III.B.2., *infra*) would count all contributions equally in measuring whether a recipient qualifies as a charity. However, the objection still remains that certain economic classes are far more able to give than others, and would therefore have a stronger force in the market in altruism.

<sup>130</sup> C. KUKATHAS & P. PETTIT, *supra* note 120, at 36–59 and R. WOLFF, *UNDERSTANDING RAWLS* 60–63 (1977) are useful for parsing the essential from the nonessential in Rawls' complex and often dense exegesis.

<sup>131</sup> J. RAWLS, *supra* note 27, at 12; see also *id.* at 136–42.

disadvantaged class. If the law might have been adopted by voters operating behind this 'veil of ignorance,' then [it is just].<sup>132</sup>

In our context, the veil of ignorance provides a convincing answer to why low demanding majorities are required to pay higher taxes in order to support the public good desires of high demanding minorities. Under the veil of ignorance, we have no notion of whether, for a particular collective good, we will be in the majority of the electorate that subsidizes high demanders or whether we will be in the minority that is forced to rely on voluntary initiative. Therefore, from the original position, we should be eager to endorse a use of the exemption that spreads over society generally a portion of the cost of providing a needed public service that the majoritarian political process is structurally incapable of subsidizing directly. We are protected if we should land in the disenfranchised group, but the burden is not oppressive if we do not. Thus, the charitable tax exemption might be thought of as a form of mutual social insurance that most people<sup>133</sup> would agree to opt into.<sup>134</sup>

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<sup>132</sup> Merritt, *Communicable Disease and Constitutional Law: Controlling AIDS*, 61 N.Y.U. L. REV. 739, 787 (1986). As Merritt observes, "Rawls himself saw that the idea of the original position can be used to measure the fairness of specific laws." *Id.* at 786 n.232. Rawls describes a "four-stage sequence" by which the technique of the hypothesized consensus in an original position is applied: first, to produce very general principles of justice (such as "each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others"); second, to construct a constitution and a basic political form; third, to enact specific laws; and fourth, to apply those laws in particular situations. Each step is to be governed by the dictates produced by the prior: the constitution must be consistent with general principles of justice, laws consistent with the constitution, and adjudication consistent with laws. Thus, Rawls does not advocate that we harken back to the rarified original position at each stage. Nevertheless, he retains elements of the original position at each stage, since at each the decision makers are still subject to a form of the veil of ignorance. The veil is nearly (but not absolutely) complete at the first stage, it is partially lifted in order to form the constitution, and lifted still further to enact legislation—all as needed to make the decision with the particularity required at each stage. But we are still to suppose that, in crafting just legislation, legislators (acting as model ethicists and not as political representatives) are not to consider the particulars about themselves or their constituents. J. RAWLS, *supra* note 27, at 196–201, 358.

<sup>133</sup> We have relaxed the unanimity principle, as is appropriate under Rawls' analysis, because as the decisions to be made become more specific and less in the nature of broad principles of justice, more facts about society must be revealed in order to inform the hypothesized decisionmakers, and, as this occurs, it is more likely the decisionmakers will adopt idiosyncratic views. See J. RAWLS, *supra* note 27, at 200. Nevertheless, we believe the argument is powerful enough that a high degree of consensus can be expected, perhaps even unanimity.

<sup>134</sup> The donative theory is also consistent with Rawls' "difference principle," which in essence is a much stronger, but more controversial, application of the analysis contained in text. In simplified form, Rawls reasons that one of the two primary principles of justice that derives directly from the idealized original position is that an unequal distribution of



Elitism is not a valid objection because of the reciprocity of the charitable exemption among different donative groups.<sup>135</sup> Using Hansmann's illustration, rich Met-goers will pay somewhat higher taxes to support the perhaps more provincial interests that happen to attract donations in Peoria.<sup>136</sup> Thus, the apparent unfairness exists only at a charity-specific level. At a more structural level of rule optimality, all taxpayers are likely to benefit from the donative exemption since those who unwillingly contribute to the charitable causes of others will likewise receive support for their philanthropic interests. The fact that those able to give the most will tend to receive the larger subsidy is a just inequity because it is necessary in order for those who are least advantaged to receive any subsidy.<sup>137</sup>

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economic privileges is just only if it is reasonably calculated to enhance the position of those who are in the worst position. *Id.* at 83. Thus, Rawls assumes that everyone in the original position is an extreme risk avoider: each chooses governing principles according to the "maximin rule" which assumes that one's place in society is selected by his worst enemy. *Id.* at 151-57. A use of the exemption that protects political minorities satisfies this condition. However, Rawlsian support for the donative theory does not depend on his controversial difference principle or maximin strategy. A donative theory may be derived directly from the original position analysis without adopting the extreme assumptions of risk aversion that underlie these arguments. *See* B. BARRY, *THE LIBERAL THEORY OF JUSTICE* 108-15 (1973) (critique of the maximin rule); C. KUKATHAS & P. PETTIT, *supra* note 120, at 39-42 (same).

<sup>135</sup> This explanation assumes that everyone donates, but under certain assumptions, it holds up even for those who do not donate to anything. There may be potential donors who desire to support undersupplied public goods, but who do not wish to engage in the "search costs" to determine which, among many competing objects of charity, are the most deserving. For them, the exemption would operate like the United Way: they pay marginally more taxes to be distributed as an implicit tax subsidy according to the donative choices made by others. Such a system benefits all participants even though some participants are not actual donors.

<sup>136</sup> Hansmann's observation highlights another concern of more significance, however. The smallness of the group may weigh against crediting its donations if, as a result of greater group cohesiveness, social stigma, ostracism, or the like, very little free riding occurs in group donations. This defect can be corrected by adjusting the threshold level of donative support required to qualify for the exemption, or by disqualifying altogether organizations that do not attract donations from a sufficiently large number of donors. *See infra* text accompanying notes 232-39, 252-56.

<sup>137</sup> *Cf.* Simon, *Tax Treatment*, *supra* note 51 (concluding that the "dynastic" quality of the deduction is an acceptable imperfection in the system). It might be possible, however, to correct for social inequities by counting gifts from rich patrons less than those from the poor, although this would impose extreme administrative burdens. *Cf.* Part III.B.2.d. (differentiating between the size of gifts, relative to other gifts received by the same entity). Also, this would not help those who are the very worst off and, therefore, unable to donate at all. Indeed, the wealth-neutral approach is likely to benefit the poor more because they are frequent objects of donations and thus the accompanying tax subsidy. Finally, the apparent regressivity of a donative exemption is countered by observing that the reciprocal support the rich will provide through the tax system to the favored activities of others will

The donative theory is necessary for this justification of the charitable exemption to hold because, from the original position, it is impossible to compose an ideal statute that compiles a permanent itemization of those activities that meet our criteria for exemption. As a result, in order for every deserving group in society potentially to benefit from the exemption, we must employ a concept of charity that is open-ended as to subject matter but bounded by a requirement of some demonstrated need for public subsidy. The donative theory of the charitable exemption operates precisely in this fashion by automatically subsidizing whatever activities garner substantial voluntary support from the community.

Thus, properly understood, the charitable exemption has a much stronger moral base than most legislation. Like the principles theories of justice derived from Rawls' original position, it is blind to individuals' "conception of the good." As Rawls states, "other things equal, one conception of justice is to be preferred to another when it is founded upon markedly simpler general facts, and its choice does not depend upon elaborate calculations in the light of a vast array of theoretically defined possibilities."<sup>138</sup> The donative theory of the exemption, in stark contrast to other tax legislation, partakes remarkably of these qualities of generality.

### 3. *Nozick's Libertarian Theory of Justice*

According to Nozick, any activity of government that goes beyond the role of a "minimal, nightwatchman state" violates the rights of its citizens. The minimal state is "limited to the narrow functions of protection against force, theft, fraud, enforcement of contracts, and so on." Consequently, "the state may not use its coercive apparatus for the purpose of getting some citizens to aid others . . . ." <sup>139</sup> In other words, any taxation that accomplishes a redistributive purpose (rather than a protective, policing purpose) is illegitimate. The illegitimacy of taxation by the welfare state might suggest as a Nozickian justification for the charitable exemption the banality that an absence of taxation, in whatever form, is better than its presence. But generalized tax opposition does nothing to justify the particular form of exemption that applies to charities, or to instruct us what are charities for purposes of the exemption. On surface inspection, a Nozickian appears to have nothing more to contribute to the debate than the argument that all tax exemptions are equally valid, whether they are for charities or for brothels, since Nozick's brand of extreme libertarianism provides no half-way principles for shaping society's laws within an imperfect structure. Although in the ideal state of affairs one might favor

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tend to be characterized by at least an equal degree of progressivity (perhaps more) since the rich have more income and property to tax, and are sometimes taxed at a higher rate.

<sup>138</sup> J. RAWLS, *supra* note 27, at 142.

<sup>139</sup> R. NOZICK, *supra* note 120, at ix.

private initiative and cooperation as a complete alternative to government, we do not live in a world that even approximates this ideal. Instead, philanthropy exists on a small island surrounded by a sea of government filled with its many funding vessels. It seems of little consequence that this island too might be swamped by taxation.

Indeed, one might expect a Nozickian to argue *against* the charitable exemption on the grounds that, within an impure state where taxation is the norm, an exemption constitutes an implicit subsidy to the exempt activity. Therefore, the failure to tax some institutions itself might be viewed as a form of illegitimate redistribution.

Deeper reflection on Nozick's philosophy, however, reveals powerful theoretical support for a charitable exemption founded on donative principles. Under the libertarian view, philanthropy is not merely residual to the failure of government to supply a good that is not available through the private marketplace; instead, given the libertarian view that government's proper role is limited to preventing citizens from encroaching on each others' rights, philanthropy is the primary alternative to market failure.<sup>140</sup> "The only morally legitimate way that will work for society to provide [public] goods is the encouragement of private philanthropy. So there is a major role for private philanthropy in a free democratic society, a role that becomes more and more significant as one becomes stricter and stricter in one's libertarian approach."<sup>141</sup>

The donative theory garners additional support from the libertarian moral outlook by undoing the redistributive characterization that otherwise might apply to an implicit tax subsidy. Under the donative theory, the exemption's implicit subsidy is conferred not to those who are deemed by government to be less advantaged, but instead to those objects that individual donors desire but are unable to purchase in a market transaction.<sup>142</sup> Thus, the donative theory, properly understood, confers a subsidy in order to satisfy the *donor's* desire to rid the world of hunger, not principally to satisfy the appetites of *the hungry* per se. In rigorous theory, the subsidy benefits the recipients of the charity secondarily only as a means of accomplishing the donors' desires.<sup>143</sup>

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<sup>140</sup> *Id.* at 265.

<sup>141</sup> Brody, *Private Philanthropy and Positive Rights*, 4 SOC. PHIL. & POLICY 79, 85–87 (Spring 1987).

<sup>142</sup> See *supra* text accompanying notes 9–20; *supra* note 33. In the case of donors who seek only public recognition from their gifts, the subsidy is conferred to those proxied (putative) donors whose recognition the actual donor seeks.

<sup>143</sup> Nozick can be read as opposed to this conceptualization when he devotes several pages to debunking the public goods justification for government spending. R. NOZICK, *supra* note 120, at 265–68. In so doing, Nozick maintains that no free-rider disincentive to giving disables voluntary relief of societal ills because the following two options are open to all who are concerned about those ills: (1) donating to specific individuals, which will fully confer to the donor the satisfaction of having solved a discrete portion of the problem; or (2)

This conception of the exemption's subsidy dampens its redistributive quality by orienting the purpose of the subsidy from one of taxing the wealthy in order to support the needy, to one of relieving from government burden those acts of individual initiative that are directed toward satisfying a private desire that can only be met through a public good. The donative theory of the charitable exemption is necessary to save it from the libertarian accusation of being merely another redistributive tool of government because only this theory judges the needs of the recipients by the desires of voluntary donors. In sum, in a society where illicit taxation exists, libertarians must view the implicit support for philanthropy conferred by the charitable exemption to be at least a second best option. In the libertarian view, if there is any proper governmental role in supporting social causes, it would be this minimal role of conferring a shadow subsidy.

#### 4. *Classic Liberalism and the Value of Pluralism*

Rawls and Nozick present very intricate versions of liberal moral theory, but even the most rudimentary form of liberalism requires the donative theory. A fundamental tenet common to all liberal theories of justice is that members of society are autonomous moral agents, each free to pursue his own notion of the good. This elemental freedom constitutes a basic constraint on the political sphere. The charitable exemption partakes of this autonomous tradition. It is said to be born out of the "spirit of classic liberalism," whose "dominant tenets . . . were distrust of government and faith that the progress and well-being of mankind could best be achieved by natural forces, harmonizing the individual actions of men who were left untrammelled."<sup>144</sup> Perhaps the strongest statement of this view is a frequently-quoted explanation from Harvard President Charles

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to the extent the donor is satisfied only by curing the societal ill at a macro level (by wiping out poverty, hunger etc.), those who are like minded are free to band together voluntarily to form a consortium that agrees to give only on the condition that all other members contribute. However, Nozick fails to grapple with the considerable transaction costs that inhibit the formation of such large contractual organizations of contributors, as well as the practical difficulty of ensuring that all who in fact derive psychic gratification from the organization's activity are identified and signed up. Nagel, *Libertarianism Without Foundations*, in J. PAUL, *supra* note 120, at 199 (this reliance on voluntary relief of poverty "is no more plausible coming from Nozick than it was coming from Barry Goldwater"). Nozick is willing to overlook these obstacles to philanthropy because, ultimately, he views the alternative of government coercion as illegitimate regardless, unless every single individual who is taxed in fact consents to the tax.

<sup>144</sup> Belknap, *supra* note 4, at 2031; *see id.* at 2030 (stressing the consistency of the charitable exemption with "the spread of the laissez faire doctrine" which "lent color of philosophic sanction to a process" where "[p]rivate relief was deemed more efficacious than governmental").

Eliot in 1872 of why a system of private educational institutions supported by tax exemptions is superior to one of direct government funding:

[T]he exemption method fosters public spirit, while the [government] grant method . . . annihilates it. . . .

. . . .

. . . The exemption method fosters the public virtues of self-respect and reliance; the grant method leads straight to an abject dependence upon that superior power—Government. The proximate effects of the two methods of State action are as different as well-being from pauperism, as republicanism from communism.<sup>145</sup>

In order for these liberal, pluralistic benefits to be fully realized, however, it is necessary to formulate the charitable exemption according to the donative theory. Only under this theory is the charitable subsidy distributed automatically based on autonomous decisions by individual donors that determine which activities within the nonprofit sector are socially valued.<sup>146</sup> Fashioning the exemption under the community benefit theory, for instance, would relegate it to merely another mechanism for the government to make, in effect, direct spending decisions by selecting which nonprofit activities confer a sufficient benefit to the community to deserve tax relief.<sup>147</sup> We might instead call on the judiciary to define charitable, as occurs under the approach that draws the exemption's substantive content from the common law of charitable trusts, but it is impossible to promote pluralism and diversity of view by

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<sup>145</sup> 2 CHARLES W. ELIOT, *THE MAN AND HIS BELIEFS* 690, 691 (W. Nielson ed. 1926) (quoted in Belknap, *supra* note 4, at 2038–39). Further quotations of Eliot and more explanation of the context of his remarks are found in Bittker & Rahdert, *supra* note 4, at 332. See also *Texas Monthly v. Bullock*, 489 U.S. 1, 13 n.2 (1989) (religious groups are exempt because they “enhance a desirable pluralism of viewpoint and enterprise”); Belknap, *supra*, note 4, at 2036–37 (the tax exemption “maintain[s] [a] rich diversity of values and abilities, . . . intellectual freedom, multiplicity of viewpoints and interest, and diversity of individual inspiration and action”); cf. J. DOUGLAS, *supra* note 23, at 129 (“It is [the] ability to tolerate different views of the public good that the pluralistic philosophy sees as the characteristic of a free society. Voluntary organizations are one of the means—indeed a necessary and essential means of putting that philosophy into practice.”)

<sup>146</sup> Cf. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 20 U. SO. CAL. TAX INST. 27, 39 (1968) (the charitable deduction affords citizens the chance to participate in public service, organizes part of our society through nongovernmental means, allows individuals to voluntarily tax themselves and effectively direct where a portion of their (otherwise) tax dollars will go, and allows individuals to make their influence directly known on the public's welfare).

<sup>147</sup> More troubling still, these normative political judgments would be made by revenue agents rather than elected officials or agencies in charge of substantive social policy.

making these judgments through an institution that necessarily reflects collective societal values.<sup>148</sup>

Those moral theorists who stress the value of pluralism in the third sector thus help us to understand why only the donative theory is compatible with the present structure of the charitable exemption. Whereas any other theory delegates discrete value judgments to government decisionmakers,

the essence of the advantage of th[e donative] system is that it is automatic. The government does not control the flow of funds to the various organizations; the receipts of each organization are determined by the values and the choices of private givers. The donors determine the direction of their own funds, and the distribution of "tax savings" as well.<sup>149</sup>

One must be careful, though, in relating these noble thoughts to the humble tax exemption, for some exemption advocates would rely on such arguments of moral superiority to extend the exemption to the entire nonprofit sector, contending that, in any of its activities, it offers a valued alternative to markets and government.<sup>150</sup> This position too loosely accounts for the benefits of

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<sup>148</sup> Cf. *Stanford v. Kentucky*, 492 U.S. 361, 369, 370-71 (1989) (eighth amendment requires the Court to look to "conceptions of decency . . . of modern American society as a whole" and to find a "settled national consensus"); *Michael H. v. Gerald D.*, 491 U.S. 110, 121-27 (1989) (same, in order for an asserted liberty interest to be protected by substantive due process).

This conflict would be particularly severe if courts were asked to play the role of social arbiter for the worth of religious organizations. See *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1, 13 n.2, (1989) ("inquiry into the particular contributions of each religious group 'would introduce an element of governmental evaluation and standards as to the worth of particular social welfare programs, thus producing a kind of day-to-day relationship which the policy of neutrality seeks to minimize.'").

<sup>149</sup> Belknap, *supra* note 4, at 2039.

<sup>150</sup> For example, see J. DOUGLAS, *supra* note 23, at 160:

[T]he way the idea of democracy is developed in the western world, [it] contains two different strands; one emphasizing the individual and hence diversity and one emphasizing the collectivity and hence uniformity. . . . The institutions of the Third Sector are one of the principal sources of the flexibility that enables a free society to preserve both strands. They thus avoid both the practical injustices and the logical contradictions that would flow from relying too heavily either on self-regarding market forces or an all-embracing role for government.

See also Atkinson, *supra* note 5, at 629 (Extending the exemption to virtually all nonprofits "would necessarily promote the acknowledged metabenefit of pluralism, because [nonprofit] provision of goods and services is an alternative to both market and governmental provision."). Atkinson's analysis of pluralism bears superficial resemblance to ours, for he speaks in terms of the pluralistic benefit of "altruism," but his definition of altruism is so broad as to encompass virtually all nonprofit organizations, regardless of their donative status. See *supra* text accompanying notes 100-18.

pluralism and the need for the exemption to promote those benefits. As Professor Gergen has explained, using the exemption simply as an encouragement for "self-expression" is not defensible because self-expression is not unique to nonprofit enterprise. "My purchase of season tickets to see the Texas Longhorns play football is a form of self-expression. Why is it not equally deserving of a tax preference?"<sup>151</sup> Only the donative theory of the charitable exemption successfully identifies the particular acts of self-expression that deserve subsidy, without undermining through excessive government involvement the pluralism that self-expression fosters. We value most the form of pluralism inherent in voluntary support of public causes because this support is the only clear sign that the benefits fostered are not available elsewhere.

### C. Tax Theory

We previously advanced as one of the donative theory's strengths its unique ability to tie together all of the major components of the taxation of charities. It explains the deduction for charitable contributions, the income tax exemption, and the property tax exemption.<sup>152</sup> So far, however, we have not examined whether the donative theory is capable of explaining the major restrictions on exempt status other than by merely accommodating them as side constraints unrelated to the core theory.<sup>153</sup> If the theory does accommodate these restrictions, its explanative power would be quite remarkable. We will examine in turn the four major restrictions on the eligibility for tax exemption: the requirement of nonprofit status, which includes the prohibition on private inurement; the exclusion of activities judged contrary to the public interest; the limitation on political activity; and the tax on unrelated business income. Although the particular justifications that underlie these disparate components of tax exemption have each generated considerable separate discussion and

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<sup>151</sup> Gergen, *supra* note 23, at 1395.

<sup>152</sup> See *supra* text accompanying note 17; Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 402-05. The donative theory also nicely explains the prevailing pattern of conferring on charities an exemption from *paying* sales tax on their *purchases*, but not on *charging* sales tax on their *sales*. Purchases are correlated to the level of donative support, while sales are not. See *supra* note 17.

<sup>153</sup> For example, Simon explains these limitations in terms of the tax law's "border patrol function," that is, as necessary "to keep nonprofit organizations from wandering off their reservation into the territory of government and business." Simon, *Tax Treatment*, *supra* note 51, at 89-90. This metaphor, although descriptively appealing, is entirely question-begging as a normative explanation. Who is to say these areas are not the territory of nonprofits, other than the border police themselves? Without some explanation that defines the border, the proper metaphor for these restrictions is a border-creating function. Simon in fact offers some explanations for how the borders have been drawn, but few relate to the core rationale for exempting charitable entities.

litigation, the donative theory can integrate each of these components into a comprehensive theory of charitable taxation.

### 1. *Nonprofit Status*

The various federal and state manifestations of the charitable tax exemption uniformly require that exempt organizations be organized as nonprofit entities. Usually, this restriction is enforced through a prohibition on the distribution of the exempt entity's assets or profits to private individuals (the "private inurement" prohibition).<sup>154</sup> While it is sometimes quite difficult to draw the boundaries between forbidden profit distributions and permitted payments of salaries and expenses,<sup>155</sup> the basic nondistribution requirement is uncontroversial.<sup>156</sup> Nevertheless, it further reinforces the donative theory as the core explanation for exemption to observe that this limitation can be derived immediately from the donative status of exempt organizations.

The relevance of nonprofit status to the charitable exemption can be established by examining Henry Hansmann's rationale for the existence of nonprofit enterprise in (what he characterizes as) all of its major manifestations. Hansmann posits that nonprofit firms exist in those activities where the distribution prohibition solves one of a variety of market imperfections that he refers to as "contract failure." Contract failure is any instance in which consumers are unable in normal market transactions to solve effectively a difficulty in monitoring the firm's output. The primary example is the desire of donors to contribute to various forms of public goods production.<sup>157</sup> Such

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<sup>154</sup> One of the requirements of exempt status under I.R.C. § 501(c)(3) is that "no part of the earnings [of such organization] inures to the benefit of any private shareholder or individual. . . ." See also Treas. Reg. § 1.501(c)(3)-1(b)(4) (1976); see B. HOPKINS, *THE LAW OF TAX EXEMPT ORGANIZATIONS* 80-85 (5th ed. 1989); P. TREUSCH, *TAX-EXEMPT CHARITABLE ORGANIZATIONS* 92-95 (1989). State laws uniformly include a prohibition on private inurement either as an express statutory requirement or as part of the common-law interpretation of "charitable." See, e.g., Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 330 n.74 (collecting citations).

Note that the nonprofit requirement is a prohibition on the *distribution* of profits, not a prohibition on an entity *making* a profit. See, e.g., B. HOPKINS, *supra* at 232-34; Hansmann, *supra* note 106, at 501.

<sup>155</sup> This has been a particularly vexing problem with health care entities, where the IRS has perhaps gone too far in its zeal to avoid private inurement. See Colombo, *Are Associations of Doctors Tax Exempt? Analyzing Inconsistencies in the Tax Exemption of Health Care Providers*, 9 VA. TAX REV. 469 (1990).

<sup>156</sup> To our knowledge, no one has argued against it as a basic component of charitable status.

<sup>157</sup> See *supra* text accompanying notes 28-31. Hansmann also applies this explanation to commercial nonprofits—those that derive their revenues primarily from sales. As explained in the text accompanying notes 106-09, *supra*, he reasons that a similar monitoring problem can arise for complex services that are difficult for consumers to



payments suffer from a form of contract failure described as “marginal impact monitoring”: donors to a joint product cannot determine whether their small portion of the production costs has been used to enhance the output. Because a public good is not divisible, there is no severable portion that could be said to have been produced only by virtue of a particular donor’s contribution.<sup>158</sup> This is precisely the same phenomenon that gives rise to free riding, and it is the characteristic of a donation that makes it a gift rather than a purchase. As a consequence of the inability to engage in marginal impact monitoring, donors have no easy way to determine whether their gifts have actually been applied to the intended purpose.

Because of the monitoring problem, donors require some assurance that the gift was actually used for the intended purpose, rather than siphoned off by the firm’s managers. The nondistribution constraint provides this assurance by denying the firm’s managers the legal right to pay the contributions to themselves, other than as fair market value compensation for their services. This limitation enhances donors’ trust by creating some greater assurance that nonprofit firms will use their funds to increase output. It is this enhanced trust that explains why donors prefer to give to nonprofits rather than to for-profit businesses.

This positive economic theory for the existence of nonprofits also suggests a normative explanation of why *only* nonprofits should be eligible for the charitable exemption. The size of the monitoring problem and the resulting temptation for abuse suggest that a rational donor would always choose a nonprofit over a for-profit recipient, all else being equal. If a person makes a “donation” to a for-profit firm, therefore, some mechanism must have overcome the marginal impact monitoring problem. If no marginal impact monitoring problem exists, this in turn suggests that the “donation” is not a donation at all, but rather a quid pro quo exchange. Such exchanges do not suffer from the free-rider disincentive to give; hence, no case exists for a tax subsidy because the complete level of public desire is satisfied through the “donation” itself.<sup>159</sup>

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evaluate, such as day care and nursing home care. A number of other nonprofit scholars take issue with whether the trust rationale properly extends to any commercial nonprofit. *See supra* note 108. But these objections, which essentially go to whether there is a legitimate role for *commercial* nonprofits, are not germane to the present analysis since none of Hansmann’s critics disagrees that *donative* nonprofits serve the useful role that he identifies.

<sup>158</sup> This is true of only pure public goods, of which there are none. *See supra* text accompanying notes 32–35. Therefore, at some level, donations are specifically identifiable to portions of production, such as a large donation that funds an entire building.

<sup>159</sup> This situation is analytically identical to the hypothesized case of a pure act utility donation discussed earlier. The fact that giving to for-profits in fact is virtually nonexistent confirms our previous speculation that free riding attends all donative activity and that pure act utility is a rarity. *See supra* text accompanying notes 75–85.

This analysis shows that the nonprofit restriction is intimately related to the donative status of exempt organizations. In contrast, other theories are unable to centralize this basic restriction.<sup>160</sup> For instance, the government burden theory is unable to explain why the exemption should not extend to profit-making institutions that equally relieve a governmental responsibility—say, a for-profit school that relies entirely on tuition. The typical response is that the nonprofit restriction is necessary to keep the firm's owners from siphoning off the exemption to their own proprietary advantage. But competitive restraints should prevent the owners from earning more than a fair market return on their investment, and earning a fair profit benefits the community by better attracting investment capital.<sup>161</sup> Similarly, one could say that nonprofit firms that obtain their financing from borrowed capital unfairly use the exemption to the advantage of their lenders.<sup>162</sup> The donative theory elegantly resolves these quandaries by drawing a direct connection between the existence of nonprofit firms and the justification for a tax subsidy.

## 2. Activities Contrary to the Public Interest

Current exemption law contains a public policy overlay that allows the IRS to deny exemption to groups that otherwise qualify but that pursue certain goals

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To take a concrete example, one might argue that, when a donor gives to C.A.R.E. in order to "adopt" a starving child, the identifiability of the aid recipient cures the monitoring problem that attends donations. (Perhaps pictures are sent to the donor each month documenting the child's improvement.) If what motivates the donor is solely and literally the welfare of this one child, then there is no reason not to patronize a for-profit firm, just as one does in feeding one's own children. But, like family provision, no actual donation would occur since the putative "donor" has every incentive to give to the full extent of benefit derived. More likely, though, "adopting" a child is a marketing gimmick; the child would be fed by C.A.R.E. anyway and the absence of a particular \$100 gift would have an undiscernible effect on any particular recipient. From the donor's perspective, the gift is likewise probably not motivated solely by the welfare of this one child but at least in part by a more generalized desire to address child starvation worldwide, a desire that is shared by others. Thus, such a gift is most likely a classic public goods donation. The fact that few people, if any, give to for-profits for hunger relief signals that this latter motive predominates.

<sup>160</sup> See, e.g., Note, *supra* note 39, at 1634–39 (struggling to explain why for-profit religious publishers do not deserve the exemption). Hansmann's capital subsidy theory of the income tax exemption is an exception, for he explains the exemption as a means to overcome the relative disadvantage that nonprofits face in the capital markets. Hansmann, *Exempting Nonprofit Organizations*, *supra* note 5, at 72–75.

<sup>161</sup> Indeed, property tax exemptions are frequently given to for-profit firms as inducements to locate in a community that needs new jobs.

<sup>162</sup> Or one could observe that the case for the nonprofit restriction is no greater than is the case for preventing the government from ever offering research grants to for-profit firms.

contrary to established public policy.<sup>163</sup> For example, in *Bob Jones University v. United States*, the Supreme Court held that the exemption may be denied to racially discriminatory private schools, despite the statute's omission of a general public policy requirement, and that such a requirement exists implicitly in the common law concept of "charity."<sup>164</sup> A potential objection to the donative theory is that it would overturn this public policy screen by blindly exempting any activity that attracts significant donative support from some segment of society. Such a result would force taxpayers to support a subsidy that validates the worst prejudices and meanest spirits of our populace. Of course, we could simply declare that certain donative objects are inconsistent with our core notions of what activities deserve a public subsidy, but this subjective approach to setting the definitional boundaries of the exemption imposes an external and theoretically arbitrary constraint on the donative theory.<sup>165</sup>

The donative theory solves this dilemma by offering a much more theoretically satisfactory rationale for the public policy limitation. This rationale derives from the government failure component of the donative theory discussed above.<sup>166</sup> This aspect of the donative theory posits that a subsidy for donative activity is necessary because of the apathy of the majority of the electorate: low demanding voters who could vote for a direct government subsidy will not do so because they do not value the undersupplied good or service enough to incur the entire cost of providing it. These voters, however, are willing to incur the cost of a partial, indirect subsidy (exemption) because they are not actively opposed to the subsidized activity per se; they simply do not want as much.<sup>167</sup>

However, if the donative subsidy is used to support activities of which the majority of voters disapprove, not due to diminished interest but due to affirmative distaste, there is no social mechanism for expressing these negative preferences, other than the selective withdrawal of the exemption. As a consequence, we can have no confidence that the social cost to those who disapprove of supporting the exempt activity will be paid back through others'

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<sup>163</sup> For a general discussion, see B. HOPKINS, *supra* note 154, at 65–71. The public policy requirement appears to harken back to charitable trust law. *Id.* at 69; RESTATEMENT (SECOND) OF TRUSTS § 377 comment c (1959).

<sup>164</sup> 461 U.S. 574, 586 (1983).

<sup>165</sup> Comments by Jeff Murphy and Pam Samuelson were helpful to our presentation of this problem.

<sup>166</sup> See *supra* text accompanying notes 124–27.

<sup>167</sup> Their inducement comes in the form of an implicit social contract: if those who benefit the most from an undersupplied good donate a portion of the costs of additional production, those who benefit the least will agree to the tax burden of an implicit subsidy because they in turn will receive tax support for their favored projects.

support of their causes.<sup>168</sup> The efficiency and fairness of the donative theory, therefore, is enhanced by a public policy screen that attempts to detect those extreme cases where support for an activity entails a substantial social evil, not just economic cost.<sup>169</sup>

### 3. *The Limitations on Political Activity*

The federal income tax law contains two separate limitations on the political activities of charities. First, charities lose their eligibility to receive tax-deductible contributions and certain other tax benefits related to charitable status if they engage in legislative lobbying to any substantial degree.<sup>170</sup>

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<sup>168</sup> In economic jargon, when the donative theory is applied to public goods for which the negative externalities outweigh the positive, the result is neither Pareto optimal nor Kaldor-Hicks optimal since, not only would some voters be worse off, but their suffering might exceed the enjoyment fostered by the exemption.

<sup>169</sup> This position is consistent with the Supreme Court's statement in *Bob Jones* that the purpose of a charitable entity may not be "illegal or violate established public policy." *Bob Jones Univ. v. United States*, 461 U.S. 574, 591 (1983). Obviously, judgments concerning when public policy is "established" in other circumstances require a modicum of subjectivity and with subjectivity comes the potential for misapplication. The Supreme Court recognized this problem, which is especially troublesome when the initial authority passing on exemption is the tax collector, and admonished in *Bob Jones* that the exemption should be denied "only where there can be no doubt that the activity involved is contrary to a fundamental public policy." *Id.* at 592. For instance, public policy opposition could be safely asserted if the majority of voters have expressed a specific legal prohibition, such as by enactment of anti-discrimination legislation.

<sup>170</sup> I.R.C. § 501(c)(3) states that an entity will be exempt only if "no substantial part of [its] activities . . . is carrying on propaganda or otherwise attempting to influence legislation." I.R.C. § 501(c)(3) (1988). Although a violation of this prohibition (repeated in § 170) can result in loss of exemption under this subsection, entities that engage in substantial legislative lobbying may be eligible for exemption under § 501(c)(4). B. HOPKINS, *supra* note 154, at 311-13. Accordingly, the lobbying restriction really translates into a limit on the ability of organizations to qualify for the special tax benefits that are inherent in § 501(c)(3) status (as opposed to 501(c)(4) status), such as the ability to receive tax-deductible contributions under § 170, and the ability to issue bonds on which the interest income is tax-exempt under § 145.

I.R.C. § 501(h) contains mechanical tests to determine when expenditures for legislative lobbying have become "substantial," although an entity is not required to use this procedure and can instead rely on sparse common-law interpretations of "substantial." I.R.C. § 501(h) (1988). For a general discussion of the lobbying limitations, see B. HOPKINS, *supra* note 154, at ch. 13; P. TREUSCH, *supra* note 154, at 263-303; Chisolm, *Exempt Organization Advocacy: Matching the Rules to the Rationales*, 63 IND. L.J. 201 (1987) [hereinafter Chisolm I].

The IRS recently issued detailed (and highly controversial) regulations concerning the scope of lobbying permitted by § 501(c)(3). See generally McGovern, Accettura & Skelly, *The Final Lobbying Regulations: A Challenge for Both the IRS and Charities*, TAX NOTES, Sept. 3, 1990, at 1305.

Second, the organization cannot to any degree participate in political campaigns on behalf of candidates for public office.<sup>171</sup> State case law similarly indicates that excessive political activity will result in a denial of charitable classification for state property and sales tax exemptions.<sup>172</sup> Prior commentators have noted that the rationale for these provisions is muddled, seemingly a conflux of historical accident and political expediency.<sup>173</sup> Although specific abuses have played a role in shaping current law, political activity is not inherently evil; indeed, it is the foundation of our system of government and enjoys a number of legal protections.<sup>174</sup> Moreover, initial impressions suggest that the donative theory would support political activity inasmuch as entities that qualify for exemption under this theory by definition suffer from government failure and therefore are demonstrably in need of more political clout.<sup>175</sup>

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<sup>171</sup> I.R.C. § 501(c)(3) states that an entity cannot "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." I.R.C. § 501(c)(5) (1988). The IRS has indicated that there may be a limited de minimis exception to this rule. See Chisolm I, *supra* note 170, at n.55. But even with this allowance, the nearly absolute ban on campaigning is more strenuous than the limitation on legislative lobbying, which clearly contemplates that exempt organizations may engage in lobbying to some (insubstantial) degree. Direct campaign activity also appears to be prohibited under § 501(c)(4), see B. HOPKINS, *supra* note 154, at 313, which means that direct participation in campaign activity disqualifies a charity from tax exemption as well as deductible donations and the other benefits attaching to 501(c)(3) status.

<sup>172</sup> However, the state statutes are generally less specific in this regard. See Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 330 n.74.

<sup>173</sup> See P. TREUSCH, *supra* note 154, at 263-64; Clark, *The Limitation on Political Activities: A Discordant Note in the Law of Charities*, 46 VA. L. REV. 439, 466 (1960); Chisolm, *Politics and Charity: A Proposal for Peaceful Coexistence*, 58 GEO. WASH. U.L. REV. 308, 337 n.130 (1990) [hereinafter Chisolm II]; Chisolm I, *supra* note 170, at 207-08.

<sup>174</sup> The major one, of course, is the first amendment protection for free speech. See generally, B. HOPKINS, *supra* note 154, at 275-80; Chisolm II, *supra* note 173, at 319-26.

<sup>175</sup> In fact, this is exactly the conclusion reached by Professor Chisolm in her detailed work on the legislative lobbying prohibition. Chisolm I, *supra* note 170, at 277-99. Professor Chisolm argues that current law discriminates against organizations that use legislative lobbying instead of other tools such as litigation or public education to foster "system change." (She also questions the IRS's apparent uneven enforcement of the lobbying limitation.) However, she does not argue for a complete lifting of the lobbying restrictions. Instead, she, like us, and like the current law, would strike a compromise between the need to lobby and the goals of the charitable exemption. Her compromise, however, would be somewhat more generous toward lobbying than ours. Her basic conclusion is that certain entities which provide representation for chronically underrepresented minorities should be exempt from lobbying restrictions. Identifying these organizations would be based upon a combination of objective criteria, such as donations, and a subjective test regarding the organization's purposes. See *id.*

The written debate on the political activity limitations spans every conceivable variation. See *id.* at 288-89. As Chisolm notes, other commentators have suggested that the

Further reflection on the government failure component of the donative theory, however, demonstrates support for at least some limitation on political activity by charitable entities. A case for indirect subsidy through the tax system exists only if the benefitted group is unable to convince the government to provide a direct subsidy. To the extent that an organization is engaged in lobbying or campaigning, we must assume that this activity is directed at improving its legislative fortunes, either by achieving direct government subsidy for its activities or by the passage of favorable legislation making it easier to accomplish its objectives.<sup>176</sup> The political activities of such an entity do not demonstrate government failure; they negate it.<sup>177</sup> A tax subsidy for a lobbying or campaigning organization becomes a "double-dip:" it subsidizes the activity of attempting to achieve further subsidization, much as if one were to count as donations those funds that are used merely to generate more donations.<sup>178</sup>

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lobbying restrictions be dropped completely, Fogel, *To the IRS 'Tis Better To Give Than To Lobby*, 61 A.B.A. J. 960, 961 (1975); that lobbying restrictions be liberalized through "more flexible" Treasury interpretation but that the restrictions on political activity be kept intact, Clark, *supra* note 173, at 462, 464; or that permissible lobbying be judged by the relationship between the lobbying and the exempt purpose of the entity, Caplin & Timblie, *Legislative Activities of Public Charities*, 39 L. & CONTEMP. PROBS. 183 (1975).

<sup>176</sup> This assumption mirrors the lobbying limitation in current law, which does not include "nonpartisan analysis, study or research" in the definition of impermissible lobbying. I.R.C. § 4911(d)(2)(A) (1988). That is, prohibited lobbying occurs only when the organization promotes a specific legislative result favorable to itself. However, the line between permitted nonpartisan activity and prohibited lobbying is not always clear, and IRS enforcement may be variable. See Chisolm I, *supra* note 170, at 229-33. The final lobbying regulations attempt to clarify both the definition of lobbying and what constitutes "nonpartisan analysis." Treas. Reg. § 56.4911-2 (1990); see McGovern, Accettura & Skelly, *supra* note 170, at 1306-09, 1311-12.

<sup>177</sup> See Pepper, Hamilton & Sheetz, *Legislative Activities of Charitable Organizations Other Than Private Foundations*, in 5 COMMISSION PAPERS, *supra* note 4, at 2917, 2923, for a similar argument based upon the government burden theory of exemption. These authors observe that the government only *increases* its burden by exempting entities that attempt to squeeze more money out of the government. Professor Chisolm responds that this "double dipping" argument is weak because allowing charities to lobby is unlikely to cost the government much, either because taxing charities is unlikely to generate much revenue or because their lobbying efforts are feeble. See Chisolm I, *supra* note 170, at 249. This response does nothing to counter the solid theoretical basis for restricting lobbying; it only argues that the restriction is likely to have little effect in practice. But this is an argument that cuts both ways. If the restriction is of little practical importance, why bother to remove it? If, on the other hand, lobbying is important to charities (as Chisolm surely must believe), it must work to some significant degree and, to that extent, it will indeed increase government burden (or, under our theory, negate government failure).

<sup>178</sup> Accordingly, as noted below, see *infra* text accompanying notes 280-83, in determining what percentage of an organization's revenues come from donations, we would deduct expenses for fundraising and use only the "net" donation figure. Our rationale is that the proportionality criterion requires that the subsidy provided by tax exemption be aimed at

Political activity tends to undermine the case for a donative subsidy because, where such activity plays a significant part in attracting donations, the donations no longer signal the undersupply of a good through market or government mechanisms.<sup>179</sup> For nonpolitical organizations, donations partially replace purchases or grants by supporting additional production of the undersupplied good, but only partially because of the free rider disincentive to give. If, instead of supporting increased production, donations are used to negate the government failure, there is no systematic basis for assuming that donations alone are not enough to achieve the optimal level of production.<sup>180</sup> In contrast, attempts to meet the entity's objectives through litigation or public education are not tainted by their ability to self-correct for government failure because they are outside the political arena.<sup>181</sup>

We do not mean to suggest, however, that *all* political activity by charities should be prohibited, any more than a donative entity should have its exemption revoked for engaging in unrelated business activities.<sup>182</sup> Admittedly, the chance exists that an entity's lobbying efforts will fail, resulting in a corresponding need for subsidization. The need to lobby is particularly acute

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the undersupplied good, not at expenses for achieving donative status. Here, we face an analogous problem of unduly amplifying the subsidy; accordingly, we have suggested a similar approach for subtracting lobbying costs from the donative base in order to control the incentive to generate funds to do nothing but lobby. *See infra* text accompanying notes 284-86.

<sup>179</sup> One might attempt to collapse this analytical distinction between the undersupplied good and the government failure that causes the undersupply by arguing that lobbying and campaigning are themselves public goods, which indeed they are. (This, essentially, is Chisolm's argument. *See supra* note 175 and accompanying text.) But this supposes that political activity is an end in itself rather than a means to achieve some personal or social reward. The reward may be "political" in some measure—such as the right to vote—but if the reward is posited to be simply political activity *simpliciter*, the argument for subsidy becomes nonsensical, or, at best, question-begging. It is as if one argued for a government subsidy to be more litigious.

<sup>180</sup> True, particular groups will continue to claim they are underrepresented, but since all political action groups rely on donations, this is not predictably more true for one group than for another based simply on their donative or nonprofit status. We might conclude that underrepresentation exists for other, external reasons such as the poverty or social status of the members that make up the group, but this is not a characteristic that is shared commonly by all "charities," as that term is conventionally interpreted by the law or as we would interpret it under the donative theory. Therefore, Chisolm's proposal to use the tax exemption as a mechanism to correct for political inequality is administratively cumbersome, theoretically inelegant, and has no more foundation than using the tax exemption to correct for other economic and social inequalities. We agree that these inequalities should be addressed; we do not see why the charitable tax exemption is necessarily or even conveniently designed to accomplish this goal.

<sup>181</sup> Consequently, the IRS's advocacy group rule, if in fact it exists, is wrong, as Chisolm argues. *See Chisolm I, supra* note 170, at 215-52.

<sup>182</sup> *See infra* Part II.C.4.

where the goal of the entity cannot be purchased but must be achieved through legislative reform (e.g., civil rights). So some sort of compromise is necessary. Unfortunately, we do not know in advance when lobbying efforts will be unsuccessful or necessary; organizational goals cannot be neatly compartmentalized. The substance of civil rights might also be achieved through public education or through litigation; pollution control could be achieved through hiring workers to pick up litter as well as by enacting laws against littering. Thus we need some kind of compromise that does not prohibit political activity, but does guard against the “double-dipping” effect noted above.

In fact, a compromise is precisely what current law accomplishes. It permits some level of political activity without loss of any tax benefits and only partially withdraws those benefits when the limits are exceeded.<sup>183</sup> Nevertheless, we believe that a better compromise is possible within the confines of the donative theory that would eliminate the current disparity between legislative lobbying and political campaign activity and at the same time simplify the rules regarding political activity.<sup>184</sup> This proposal is discussed below in Part III.B.5. along with other aspects of implementing the donative theory. Our only desire at this point is to demonstrate that the donative theory supports a partial restriction on political activity and thus is broadly consistent with both limitations and allowances that have been part of the lore of charitable exemption virtually since the inception of the tax laws.

#### 4. *Unrelated Business Income*

Since 1950, the federal government has taxed income of an otherwise exempt organization that is “unrelated” to its charitable purpose. The unrelated business income tax (UBIT) resulted largely from certain highly-publicized instances of exempt organizations owning businesses completely unrelated to

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<sup>183</sup> See *supra* text accompanying notes 170–71. For example, I.R.C. § 501(c)(4), which grants exemption for social welfare organizations, does not contain a lobbying restriction. Such organizations, however, are not eligible to receive tax-deductible contributions under I.R.C. § 170, nor under the corresponding estate or gift tax provisions for charitable contributions. See B. HOPKINS, *supra* note 154, at 311–14.

<sup>184</sup> As noted below, text accompanying notes 284–86, *infra*, we cannot conceive of any reason to treat legislative lobbying differently from direct campaign activity. Both are tools for improving the fortunes of the entity through legislation. In contrast, other commentators have viewed the restrictions on direct campaign activity as more supportable than limitations on lobbying. Compare Chisolm I, *supra* note 170 (arguing for relaxed lobbying limitations for certain types of chronically underrepresented groups) with Chisolm II, *supra* note 173, at 344–52 (refusing to permit a tax subsidy for any campaign activity by charities for the same reasons rejected in the first article). See also Clark, *supra* note 173, at 462, 464 (taking a more firm stand on campaign activity than lobbying).



their charitable purpose, such as NYU's ownership of a macaroni factory.<sup>185</sup> Prior to the UBIT, court cases generally had upheld the tax exemption of an entity engaged in such unrelated businesses, as long as the profits from the business were used by the entity for its exempt purpose.<sup>186</sup> Logically, this old "destination of income" test made sense under conventional theories of the charitable tax exemption. After all, if charitable status is based upon relief of government burden, aid to the poor, or community benefit, what difference does it make where the money to perform these services comes from, as long as the funds are destined to further the worthy goal?

The conventional response to this question is that the UBIT polices "unfair competition" by exempt entities. The UBIT arose from congressional concern that the tax exemption gave an unfair economic advantage to exempt organizations competing with for-profit firms. This concern led in 1950 to the decision to tax unrelated business income as the best way to "level the playing field."<sup>187</sup> Nevertheless, commentators have noted the lack of any coherent rationale for the UBIT. The test for taxing income under the UBIT depends on whether the business is related to charitable activities and not on whether the business competes with for-profit entities.<sup>188</sup> Accordingly, exempt entities may operate businesses which in fact compete with their for-profit counterparts in the same markets, yet escape the UBIT.<sup>189</sup> In addition, the IRS has often been

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<sup>185</sup> See Dale, *About the UBIT* . . . , 18th Conf. on Tax Planning for 501(c)(3) Organizations § 9.02, at 9-5 (1990) (unpublished manuscript); Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1432 (1980).

<sup>186</sup> The "destination of income" test essentially permitted a tax-exempt charity to operate unrelated businesses tax-free as long as the proceeds from the unrelated business were used to further a charitable purpose. See generally Dale, *supra* note 185, at 9-3 to 9-5; Kaplan, *supra* note 185, at 1433.

<sup>187</sup> See Dale, *supra* note 185, at § 9.02. Similarly, most state property exemption laws limit the exemption to property used by the entity only for its exempt purpose. A hospital may be tax-exempt, for example, but an office building for private physicians owned by the hospital would not be, since it is not part of the operation of a hospital. *Mason Dist. Hosp. v. Tuttle*, 61 Ill. App. 3d 1034, 378 N.E.2d 753 (1978). Likewise, a portion of a building owned by a church and used for religious worship might be exempt under state law, but not those portions of the building rented to retail stores, *First M.E. Church v. Chicago*, 26 Ill. 482 (1861), or church-owned buildings used as residences for pastors or other religious. *Pearsall v. Methodist Episcopal Church*, 315 Ill. 233, 146 N.E. 165 (1924); *Carson v. Muldoon*, 306 Ill. 234, 137 N.E. 863 (1922). This limitation is less controversial than the UBIT since, under either conventional or donative theories of exemption, the limitation directs the tax subsidy to property actually used for the exempt purpose and thus serves to better satisfy the proportionality criterion.

<sup>188</sup> Dale, *supra* note 185, at 9-5.

<sup>189</sup> This is the case in the health care industry, for instance. See Colombo, *supra* note 155, at 515-17. Many commentators, moreover, have questioned whether the UBIT is necessary or even desirable to police "unfair competition." A number of commentators agree that a nonprofit firm is no more likely to engage in predatory pricing (a common

less than successful in defining the boundaries of relatedness.<sup>190</sup> These difficulties have recently led Congress to revisit the UBIT, inquiring whether enforcement can be strengthened and simplified, or instead whether the UBIT should be largely abandoned.<sup>191</sup>

The present confusion in federal policy regarding unrelated businesses results largely from the failure of conventional charitable exemption theories to justify the integral part UBIT plays in their explanations for the exemption. Therefore, the UBIT exists as an external constraint, imposed to control what some view as harmful side effects of the exemption. In contrast, the donative theory itself provides a theoretical rationale for some limits on unrelated activity as well as for allowing some such activity to continue. Because both the relatedness concept and the income destination argument are integral to the donative theory, it is capable of providing a much more satisfactory resolution of these two competing policies previously at war with one another.

According to the donative theory, the tax exemption is a subsidy to correct the undersupply of a good or service that suffers from the concurrence of private market and government failure, as evidenced by donative support. Thus, this subsidy should be limited to the good or service for which twin failures have occurred, that is, the good or service that induces donations. Put more concretely, a person contributes money to NYU presumably because of its educational mission, not because of any undersupply of macaroni.<sup>192</sup> As a result, there is no demonstrated need to facilitate more macaroni production;

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"unfair competition" complaint) than for-profit firms. See Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 610-11 (1989); Kaplan, *supra* note 185, at 1465-66; Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 65-66 (1972); Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1021 (1982). While some commentators recognize that entry of nonprofit firms into a particular market can create injury to for-profit investors, *id.* at 1025-30, the remedy proposed by one of these commentators is to repeal the UBIT completely so that business operations of nonprofits will be spread throughout the entire economy, thus creating less havoc in one sector. *Id.* at 1038-39. Cf. Hansman, *supra* at 626-35 (generally defending the current scope of UBIT).

<sup>190</sup> In the health care field, for example, the IRS has been blatantly inconsistent in its use of the "promotion of health" standard to define the scope of the exemption. Despite professing this as the basis for which nonprofit hospitals are exempt, it refuses to extend the exemption to health-related income that is not strictly hospital-related (out-patient care, pharmacy sales, etc.), probably because a number of peripheral health-care activities are undertaken by for-profit entities which might thereby be subjected to unfair competition. Colombo, *supra* note 155, at 516-17. But the same is true of the core hospital functions themselves.

<sup>191</sup> See, e.g., *Unrelated Business Income Tax, Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means*, 100th Cong., 1st Sess. (1987).

<sup>192</sup> One advantage of the donative theory is that it provides a more objective basis for defining the scope of "related." Related activities can be detected by inquiring of donors what induces their contribution.

any such subsidy would be disproportionate to the need for support evidenced by the existing level of donations.

This theoretical argument supporting a "relatedness" limitation on exemption, however, is somewhat at odds with the practicalities of precisely how the income tax exemption creates a subsidy effect. For instance, an exemption for an entity that receives nothing but donations produces no income tax subsidy at all since, under current definitions of income, a purely donative entity would have no income taxes to pay even absent an exemption.<sup>193</sup> Therefore, in order to create any subsidy from the income tax exemption, we must allow the exempt entity to produce a substantial amount of other nondonative income.<sup>194</sup> How much other income is appropriate becomes a question of proportionality, matching the subsidy to the level of deservedness demonstrated by donative support. This rough matching of the tax subsidy to the donative base is precisely what we accomplish when, in the following section, we set a one-third donative threshold that an exempt entity must meet in order to qualify for charitable status.<sup>195</sup>

Once we set this threshold of one-third donative support, however, the source of the other, nondonative income is of no concern. It does not matter whether it is related or unrelated.<sup>196</sup> As long as the tax savings are used to

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<sup>193</sup> See I.R.C. § 102 (1988) (excluding gifts from gross income). We note, however, that commentators have questioned the theoretical propriety of § 102: because a gift increases the consumption ability of the donee, an argument can be made that the gift should be included in the income of the donee. See generally M. GRAETZ, *supra* note 65, at 163-65; U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 37-41 (1977). Nevertheless, an entity that must rely entirely on donations probably spends most of the money it receives, so even if donations were counted as income, they most likely would be offset by expenses. See Bitker & Rahdert, *supra* note 4, at 309 (noting that certain charitable organizations essentially act as conduits, spending their receipts on their charitable purpose). However, an exemption from property tax might still be a major subsidy. For further discussion of the relationship between the degree of donative support and the size of the tax subsidy, see *infra* notes 224-27 and accompanying text.

<sup>194</sup> This is not necessarily true of the property tax exemption since, absent an exemption, property owned by a donative entity would be taxable. Nevertheless, the size of the tax relief may still fall short of the need for a subsidy. Depending, then, on the legislature's assessment of the extent of free riding, see *infra* text accompanying notes 235-36, states may or may not want to extend the property tax exemption to portions of property that are not donated, that are not supported entirely by donated revenues, or that are not related to activities that receive substantial donative support.

<sup>195</sup> See *infra* text accompanying notes 228-31.

<sup>196</sup> For example, assume two museums with similar collections, each of which receive donations of \$400,000 per year, and expend \$500,000 on museum costs. Museum A gets its extra \$100,000 from admission revenues ("related" income) using volunteer workers. However, Museum B charges no admission because it receives \$100,000 income from macaroni sales (net of \$300,000 of expenses in macaroni production). Both entities meet the one-third donative threshold (Museum A is four-fifths donative; Museum B is one-half donative (\$400,000 out of \$800,000)). Since each entity is expending the same amount of

produce the undersupplied good or service, the donative theory would exempt unrelated business income (up to two-thirds of the entity's total operations) in order to overcome the market failure that induced the donations.<sup>197</sup> Thus, as we propose to implement the donative theory, there would be no need for the UBIT as a separate check on exempt status.

This end result of the implementation of the donative theory appears superficially to be nothing more than an adoption of the old destination of income test, and a refutation of the relatedness test. In fact, the donative theory resolves these competing theories through the compromise entailed in setting the donative threshold. Unlike the destination of income test, which would permit exemption of *any* amount of income from unrelated business as long as the money is spent on a purpose that is in any way "charitable," our implementation of the donative theory contains a substantial restriction on the subsidy given to unrelated activity: the receipts from unrelated activity may not exceed by a certain percentage the entity's donative base. Thus, to the extent we retain the requirement of a substantial donative base, we recognize the cross-subsidization concerns that form the basis for the UBIT; but to the extent we allow the exemption to extend to other, nondonative activity, we recognize the logic of the income destination argument. In sum, the threshold requirement embodies in theory the idea that the subsidy must be matched to the level of deservedness, while avoiding the practical difficulties of defining relatedness or identifying undue competitive effects.

### III. PRACTICAL IMPLEMENTATION OF THE DONATIVE THEORY

The donative theory is theoretically superior to other theories of the charitable tax exemption in explaining not only the core concept of what is a charity but also the major limits on the exemption of charitable organizations under both federal and state tax law. Nevertheless, the most theoretically elegant theories can fail in the face of insurmountable problems of practical

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money on its museum activities, and those activities are substantially supported by donations, we would give each the same amount of subsidy (an abatement of taxes on the \$100,000 of otherwise taxable income).

<sup>197</sup> This assumes, of course, that the exempt entity in fact uses the tax savings to enhance its donative activity, which suggests a troublesome need to assess and police operational spending decisions. Fortunately, the donative theory avoids this difficulty through its threshold requirement of a significant percentage of donative support. If donors are not satisfied with the organization's spending decisions, the operation of the market in altruism will cause donative support to drop off, threatening its exempt status. *See supra* text accompanying notes 86–87 (discussing how market in altruism will adjust donations over time to account for variations in perceived deservedness). Even if this does not occur, the mere fact that the organization chooses to invest more in the unrelated business will increase its overall revenues, thus tending to dwarf the donative base that is in place and threaten the organization's exempt status.

implementation.<sup>198</sup> Fortunately, most of the mechanisms necessary to implement the donative theory already exist in the Internal Revenue Code and Treasury Regulations. Our analysis in this section establishes the administrative feasibility of the donative theory by proceeding in two parts. First, we present an overview of the current regulatory scheme aimed at distinguishing publicly-supported charities from private foundations. As noted below, this regulatory scheme is not aimed at granting exemption, but rather controlling the amount of deductible contributions to different entities and guarding against abusive use of those contributions. We then compare this current scheme with the donative theory and suggest how this current regulatory system can be adapted to that theory and hence become the basis for granting exemption. We note at the outset that our intent is to cover only the major issues of practical implementation in broad outline. Undoubtedly, we will brush over some important topics that would be the subject of significant further discussion if the donative theory were adopted; at this stage, we hope to demonstrate at least that implementing the donative theory would not require a major overhaul of the existing tax systems.

#### *A. Defining a Publicly-Supported Entity Under Current Law*

Since 1954, the Internal Revenue Code has distinguished between certain types of charitable entities for purposes of limiting the deductibility of charitable gifts. As originally enacted, section 170 generally limited the deduction for charitable donations to twenty percent of the taxpayer's adjusted gross income; however, donations to churches, certain educational institutions, and hospitals were permitted up to thirty percent.<sup>199</sup> In 1964, Congress added certain publicly-supported organizations to the higher contribution limit,<sup>200</sup> but it wanted to make sure that these benefits were available only to organizations with broad-based public support and not to "private foundations," which

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<sup>198</sup> We note, however, that critics of new theories too frequently overstress the impossibility of perfect implementation while downplaying the imperfections of the status quo. As Professors Surrey and McDaniel have noted, the taxing system can be as simple or as complicated as one desires. See S. SURREY & P. MCDANIEL, *supra* note 7, at 101-02.

<sup>199</sup> I.R.C. § 170 (1954). The stated reason for the differentiation was "to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds." S. REP. NO. 1622, 83rd Cong., 2d Sess. 29, reprinted in 1954 U.S. CODE CONG. & ADMIN. NEWS 4621, 4660.

<sup>200</sup> Revenue Act of 1964, Pub. L. No. 88-272, § 209(a), 78 Stat. 19, 43 (1964). The specific reason for this addition was Congressional recognition of the "many beneficial activities carried on by various philanthropic organizations not now eligible for the [higher deduction limit]." S. REP. NO. 830, 88th Cong., 2d Sess. 58, reprinted in 1964-1 (part 2) C.B. 562.

typically are funded by large contributions from a single donor.<sup>201</sup> Accordingly, the 1964 law limits the availability of the higher contribution limit to those organizations that receive a "substantial part" of their support from the government or general public.<sup>202</sup>

A parallel provision emerged from the Tax Reform Act of 1969, which enacted a comprehensive set of rules to regulate the conduct of "private foundations."<sup>203</sup> To identify those entities potentially subject to abuse, section 509 first creates a presumption that all section 501(c)(3) organizations are private foundations. It then excepts from private foundation status those entities already subject to the higher contribution limits of section 170 and certain other entities that demonstrate broad-based public support.<sup>204</sup> The new class of publicly-supported organizations is then given the benefit of the higher contribution limits by virtue of a cross reference in section 170.<sup>205</sup> The result of the 1969 legislation is two sets of rules designed by Congress to differentiate those charities that are broadly supported by the public from those that are not.<sup>206</sup>

Since many of the rules already in place under sections 170 and 509 can be adapted to implement the donative theory, a somewhat detailed introduction to these rules is in order. We begin with section 509. In order to be classified as a publicly-supported organization under the private foundation provision, an entity must meet two tests. First, it must "normally" receive more than one-third of its total support from a combination of: (1) gifts, grants, contributions, and membership fees; and (2) gross receipts from admissions, sales of merchandise, performance of services or rental of facilities, provided that such gross receipts do not constitute an unrelated trade or business.<sup>207</sup> Two limits exist on counting support for purposes of this test. Gross receipts from sales or

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<sup>201</sup> S. REP. NO. 830, *supra* note 200, at 563-64.

<sup>202</sup> I.R.C. § 170 (1964).

<sup>203</sup> The classic private foundation is a trust funded by a single family (for example, the Fords) which uses its funds to make contributions to other charities. Throughout the late 1950s and 1960s, tax policy analysts became increasingly concerned that the general retention of control over family funds represented by the private foundation device created a potential for self-dealing between the foundation and its managers/founders. *See generally Council on Foundations, Private Foundations and the 1969 Tax Reform Act*, in 3 COMMISSION PAPERS, *supra* note 4, at 1557-59.

<sup>204</sup> I.R.C. § 509(a) (1988).

<sup>205</sup> I.R.C. § 170(b)(1)(A)(viii) (1988).

<sup>206</sup> One set, contained largely in the regulations under § 170(b)(1)(A)(vi), derives from the 1964 legislation adding certain publicly-supported organizations to the higher contribution limit enacted in 1954. The second set, which is a combination of statutory tests set forth in Code § 509(a)(2) and the regulations thereunder, drew on the IRS regulations under § 170 to further refine the difference between organizations that received broad-based public support and those that did not.

<sup>207</sup> I.R.C. § 509(a)(2)(A) (1988).

admissions (category (2)) from any one source are counted only to the extent of \$5000 or, if higher, one percent of the entity's total support for the year.<sup>208</sup> In addition, by virtue of a complex cross reference,<sup>209</sup> donations, grants, contributions, and membership fees (category (1)) will count toward the one-third support test only if the item does not exceed the greater of \$5000 or two percent of the total contributions received by the organization since its inception.<sup>210</sup> Grants or contributions from government or other publicly-supported organizations generally are not subject to either limitation.

The second test for publicly-supported status under section 509(a)(2) is that the organization may not receive more than one-third of its annual support from a combination of investment income and net unrelated business income. In short, these tests require calculation of two fractions: under the first test, the denominator is total support and the numerator consists of donations, grants, contributions, membership fees, and gross sales receipts as limited by the Code rules. This fraction must be more than one-third. The second fraction also uses total support as the denominator, but the numerator consists of gross investment income and net unrelated business income. This fraction must be one-third or less.

"Support" for these purposes is defined in section 509(d), and generally includes all types of gross receipts other than gains from the sale of capital assets.<sup>211</sup> In addition, the regulations interpret the word "normally" by averaging the preceding four taxable years, and special rules are provided for excluding from both the denominator and numerator of the relevant fraction unusual gifts that might unfavorably skew average numbers.<sup>212</sup> The tests used by the IRS to identify "publicly supported" organizations under section 170 are similar, but differ in material respects. Although the section 170 regulations

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<sup>208</sup> *Id.*

<sup>209</sup> I.R.C. § 509(a)(2)(A)(ii) states that items will count toward meeting the one-third of support test only if they are not from "disqualified persons" as defined in Code § 4946. Section 4946(a)(2) includes in "disqualified persons" a person who is a "substantial contributor," which § 507(d)(2) defines as explained in text.

<sup>210</sup> *Id.* This limitation differs from the \$5000/1% limit discussed previously in a number of ways. First, the \$5000/1% limit applies only to gross receipts from sales, admissions, etc. (items often referred to as "exempt function income") and not to contributions, grants or membership fees. The \$5000/2% limit, however, applies to everything, including contributions, grants and membership fees. Moreover, the \$5000/1% limit is based upon support (as defined in § 509) for *the year in question*; the \$5000/2% limit is based upon total contributions for *all prior years of the entity*.

<sup>211</sup> I.R.C. § 509(d) defines "support" as the sum of (1) "gifts, grants, contributions, or membership fees;" (2) *gross receipts* (not gross income) "from admissions, sales of merchandise, performance of services" and the like; (3) "net income from unrelated business activities;" (4) "gross investment income;" (5) tax revenues levied for an organization and expended on its behalf; and (6) "the value of any services or facilities" furnished by government to the entity free of charge. I.R.C. § 509(d) (1988).

<sup>212</sup> Treas. Regs. § 1.509(a)-3(c)(1) & (3) (1986).

also use a one-third-of-support threshold, they apply different limits on what "counts" as support. First, per statutory directive, gross sales receipts from activities related to the entity's exempt function are eliminated from support.<sup>213</sup> Thus admission charges by an exempt symphony orchestra society would not count either in the denominator or numerator of the support fraction.<sup>214</sup> Second, individual donations count in the numerator of the support fraction only to the extent they do not exceed two percent of the total support for the year. As with the tests under section 509, however, government grants and donations from other public charities generally count in full toward the threshold.<sup>215</sup>

While these rules are complicated, they provide an outline of two similar approaches to the problem of identifying organizations receiving broad-based donative support, which is the essential practical problem in implementing the donative theory. Moreover, as noted below, we believe that the key provisions of these rules integrate well with the donative theory and, subject to the changes and suggestions noted below, can be used as the basis for a system implementing the donative theory.

## B. *The Donative Theory Compared*

### 1. *Setting the Donation Threshold*

Our analysis of the practical aspects of implementing the donative theory must begin with the relationship between the tax exemption and the level of public support necessary to invoke exemption. As noted above, private philanthropy indicates a twin failure of government and private markets to supply a good or service and, because of the free-riding disincentive to donate, a need for an additional, indirect government subsidy to correct this undersupply. The question of an appropriate donation threshold essentially asks for a line beyond which we believe that a tax subsidy is both worthy and needed. Obviously, the best case for exemption is one in which the entity in question receives all its support from private donations, but very few, if any,

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<sup>213</sup> I.R.C. § 170(b)(1)(A)(vi) (1988); Treas. Regs. § 170A-9(e)(7)(i)(a) (1986). The statute states that support is "exclusive of income received in the exercise or performance by such organization of its charitable . . . function . . . ."

<sup>214</sup> Treas. Reg. § 1.170A-9(e)(9) example (4) (1986).

<sup>215</sup> The § 170 regulations also provide an alternative test for organizations that fail the one-third safe harbor. Treas. Reg. § 1.170A-9(e)(3) (1986). In such a case, the regulations provide that an organization can still meet the "substantial part" test of § 170(b)(1)(A)(vi) as long as at least 10% of its total support comes from government grants or donations, and the organization meets a "facts and circumstances" test which identifies other factors that indicate broad-based community support. See *infra* note 233 for a further discussion of this alternative test.



organizations would meet this test.<sup>216</sup> Even churches, which empirical studies show are most dependent on philanthropy for their existence,<sup>217</sup> engage in bake sales, raffles and that most ubiquitous nondonative activity: bingo. An exemption tied to complete donative support, moreover, would be no exemption at all.<sup>218</sup> Accordingly, what we need is a level of giving that signifies a great enough market failure that subsidization through the tax system is warranted to correct the undersupply of a desired good or service, yet not so high that the effect of the subsidy is nil.<sup>219</sup>

The discussion of a threshold, however, requires as a prerequisite a base against which to measure the threshold. The relevant inquiry here is the significance of the aggregate level of giving relative to the entity's output capacity. Put another way, we desire to measure the importance of donations to the amount of money an entity *could* spend to produce the undersupplied good or service. The simplest measure of the significance of giving is the entity's total revenues.<sup>220</sup> The portion of such revenues from donations, as opposed to

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<sup>216</sup> See WEISBROD, *NONPROFIT ECONOMY*, *supra* note 23, at 197, Table C.4 (citing Smith & Rosenbaum, *The Fiscal Capacity of the Voluntary Sector* (unpublished paper)). Relying on statistics compiled from 1980 data, Weisbrod found that the class of organizations that relied most heavily on donations were religious organizations, with 93% of total revenues coming from private giving.

<sup>217</sup> *Id.*

<sup>218</sup> See *supra* note 193.

<sup>219</sup> We would require all organizations to meet the donative threshold, even if they engage in an activity that might be considered "per se" exempt by virtue of being specifically listed in the relevant statute as qualifying for charitable status (religion, education and social welfare are the classic examples). Our rationale is, first, that this specific enumeration is illustrative of and inclusive within the concept of charitable, rather than cumulative to that concept. See Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 311-12. For this reason, all such institutions must continue to meet the basic requirements of charitable status. Imposing a donative threshold is therefore just as consistent with the statute as excluding those institutions that engage in activities contrary to the public interest, or imposing other implicit concepts of charity. *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983). Thus, it is more accurate to say that these enumerated activities are presumptively exempt, not per se exempt, since their historically donative status is subject to rebuttal by a showing that a particular institution fails to follow the historical pattern. See *infra* note 229 (discussing educational institutions as border-line cases under the donative threshold); see also *infra* text accompanying notes 232-33 (recognizing special status of historically exempt activities).

<sup>220</sup> See generally B. WEISBROD, *THE VOLUNTARY NONPROFIT SECTOR* 75 (1977); Weisbrod, *Private Goods, Collective Goods: The Role of the Nonprofit Sector*, in *THE ECONOMICS OF NONPROPRIETARY ORGANIZATIONS* 150 (1980) [article hereinafter Weisbrod, *Private Goods*] (both using gross revenues as a measure of various types of goods output). Obviously, one could choose other measuring sticks, such as net worth, net revenues or some modification of these or other measurements. None of these other yardsticks, however, seems as relevant as gross receipts to the issue at hand: whether the undersupply of a good or service is significant enough to warrant subsidization through the

other sources such as sales, investment income or government grants, will indicate the extent to which the entity's production is still suboptimal due to the free riding disinclination to give. Moreover, the entity's entire operation is what will receive the benefit of the exemption and will produce the subsidy effect. Accordingly, the base against which to measure donations is simply the gross revenue of the organization.

Section 509(d) conveniently provides a good definition of the gross revenue base, with two exceptions. We see no reason to eliminate receipts from the sale or exchange of capital assets from the base against which to measure the importance of donations. This exclusion is not explained in the legislative history to the 1969 Tax Reform Act and such receipts represent funds available to the entity to supply goods and services.<sup>221</sup> Second, we would include in full

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tax system. Obviously, net revenue means nothing in this equation, since an exempt organization may (perhaps ideally would) spend all its receipts on delivery of goods and services to its market and be left with zero net revenues. While a comparison of total donated assets to total net worth might have some bearing on the importance of donations to an entity's overall operation, the major problem with using a net worth comparison is that it says little about the importance of donations to an organization's delivery of goods and services *in the current year*. As set forth below, *see infra* text accompanying notes 273-76, we would require periodic re-testing of an entity's donative status, whereas an entity's net worth may have resulted entirely from a large donation made generations ago. Such an entity should not automatically be exempt today.

<sup>221</sup> Note that current law exempts "gains" from such transactions. We would continue to include just the gain, rather than the total receipt, since only the gain represents new revenues. The amount previously invested in the property (its basis, in tax jargon) has already been accounted for in the donative measurement, and hence should not be counted again. To illustrate, assume an entity received \$100 in donations in year one, and invested the money in stocks. In this year, the entity is 100% donative—that is, all its current output capability arose from donations. In year two, the entity receives \$1 in donations, but sells the stock for \$100. In this year, the entity has \$101 of output capability, but only \$1 of "new" money. The other \$100 was already counted in year one, and should be excluded from the year two calculation.

In adopting the test of "support" from § 509(d), we expressly reject the notion contained in the § 170 regulations that exempt-function income (that is, income from sales related to the performance of the entity's exempt purpose) should be excluded both from the support base and the threshold. Excluding exempt function income from the base and threshold potentially permits an entity to qualify as publicly-supported with a minor amount of donations. For example, one could envision a museum which earns \$1,000,000 in admissions receipts, and \$10,000 in donations. Although donations constitute only 1% of the total revenues in this case, excluding exempt-function income from the test base would leave us with an entity that received 100% of its base from donations. The current regulations under § 170 handle this problem by stating that an organization will not meet the tests of public support (i.e., the 33% test or the facts and circumstances test) if the entity receives "almost all" its support from gross receipts from exempt functions. Treas. Reg. § 1.170A-9(e)(7)(ii) (1986). We believe, however, that the simpler approach, as well as the better measure of the importance of donations to the entity, is to include all receipts in the measuring base.

the receipts from unrelated businesses, rather than only the net income of such business. As noted above,<sup>222</sup> we would not keep the UBIT as part of the administrative machinery of the tax exemption, because we believe the use of a donative threshold properly controls for unduly extending tax benefits beyond the core exempt activity. Thus we would not treat receipts from an unrelated business any differently from receipts from a related business.<sup>223</sup>

Having defined the base, we can now move to the threshold—that is, the percentage of the base of gross revenues that needs to come from donations in order to qualify as a “charity.” The difficulty we encounter is that, for the income tax deduction, the two relevant considerations are competing. The more donations (as a percentage of revenues) that an organization attracts, the better is its case for subsidy since the higher donation level indicates a more highly valued service and a more serious market/government failure. On the other hand, the higher the threshold, the *less* help the income tax exemption is in correcting this failure. Since donations themselves are not considered income even in the absence of an exemption,<sup>224</sup> the value of an income tax exemption per dollar of donation declines as donations increase. For instance, consider two organizations that produce and distribute religious literature, both with \$1,000,000 in gross revenues. One organization receives \$100,000 in donations and the other \$900,000. The subsidy effect created by exempting the nondonative income is eighty-one times greater for the first organization—the less deserving of the two.<sup>225</sup> The same dilemma does not present itself so starkly with respect to the property tax exemption, for there the value of the exemption will not vary according to the threshold, only according to the size

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<sup>222</sup> See *supra* text accompanying notes 192–97.

<sup>223</sup> In fact, including only *net* income from an unrelated business would run counter to the proportionality criterion. Assume, for example, two entities, one which receives \$1000 from donations and expends that \$1000 on, say, famine relief, and another which has \$100 in donations and \$900 in receipts from an unrelated business as against \$850 of expenses for that business and as a result spends only \$150 on famine relief. Obviously, the first entity is producing a far greater output of famine relief, and because that greater output is funded totally by donations, it is in greater need of subsidization. If the measuring base included only net income from the unrelated business, both these entities would be substantially donative (100% vs. 67%); by including gross receipts from the unrelated business in the measurement base, we can see that in fact the second entity is far less deserving.

<sup>224</sup> Of course, if they were, they would likely be offset by the “business” expenses entailed in spending the donations. See *supra* note 193.

<sup>225</sup> To see this, suppose the nondonative receipts of each organization are produced by selling their literature at a net return of 10% of sales revenue. The first organization has \$900,000 of sales revenue and a resulting \$90,000 profit which is otherwise taxable income; the second has \$10,000 of profit. If the corporate income tax rate were 30%, exempting the first would produce a subsidy of 27 cents per dollar of donation (\$27,000 of forgiven taxes versus \$100,000 of donations), whereas exempting the second would produce a subsidy of only one-third of a cent (\$0.0033) per dollar of donation (\$3,000 versus \$900,000).

of its property holdings.<sup>226</sup> Nevertheless, since we assume that both income and property tax exemptions will be determined by the same threshold,<sup>227</sup> setting a threshold still involves compromising these two competing considerations of deservedness and proportionality.

While this basic value judgment ultimately must be resolved in the political arena, historical experience suggests a threshold in the vicinity of one-third of gross revenues. First, the pioneering work on the economics of nonprofit institutions done by Burton Weisbrod indicates that the traditional "charitable" institutions—religious, cultural and social welfare organizations—all receive more than one-third of their revenues in the form of donations.<sup>228</sup> Thus the

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<sup>226</sup> Drawing from the example just given, assuming both organizations have the same property holdings (a reasonable assumption since they each spend the same amount—\$1 million per year—on distributing religious literature), the subsidy effect per dollar of donation from a property tax exemption would be 9 times less disproportionate than from an income tax exemption (9-fold discrepancy versus 81-fold).

<sup>227</sup> See *infra* text accompanying note 236.

<sup>228</sup> Weisbrod, *Private Goods*, *supra* note 220, at 151–60. Based on data taken from 1973–1975, Weisbrod calculated for various classes of entities the following percentage of total revenues that consisted of donations:

Cultural	90
Religious	71
Public Affairs	47
Social Welfare	41
Agricultural	41
Educational	34
Health	2

Weisbrod refers to this calculation as the "Collectiveness Index." We note that Weisbrod's Collectiveness Index included government grants but did not include the value of donated labor. As explained below, see *infra* text accompanying notes 248–49, we would exclude government grants from the donation threshold, but we would include the value of donated labor. We do not believe, however, that our modifications fundamentally change Weisbrod's observations that those organizations most associated with public goods receive more than 33% of their revenues from donations. Statistics cited in Weisbrod's later work indicate that in 1980, religious, civic, and cultural organizations all received more than 33% of their gross receipts from private donations exclusive of government grants. WEISBROD, *NONPROFIT ECONOMY*, *supra* note 23, at 197, Table C.4. With respect to donated labor, Weisbrod observed that its inclusion in the Collectiveness Index likely would cause little change in the *relative* rankings of organizations' Collectiveness Index, under the assumption that a correlation exists between donated labor and monetary donations. Weisbrod, *Private Goods*, *supra* note 220, at 154–56. In fact, Weisbrod's later work shows that the value of donated labor is very high in traditionally-exempt sectors, such as religious, health, educational, and cultural institutions. WEISBROD, *NONPROFIT ECONOMY*, *supra* note 23, at 203. For example, the value of volunteer labor to religious organizations is over twice the cost of paid labor; for educational organizations, volunteers are worth half the total paid labor costs. For the nonprofit sector as a whole, total private monetary contributions were

one-third threshold appears supported by history.<sup>229</sup> Second, the one-third number already exists in Code section 509(a)(2) and the Treasury Regulations under section 170 and therefore already has been approved by the political process and tax administrators to differentiate between levels of public support relevant to determining the level of tax subsidy.<sup>230</sup> Accordingly, the one-third number appears to be at least a good starting point for the threshold.<sup>231</sup>

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\$49.1 billion in 1980, which constituted one-third of total expenditures by nonprofits. That same year, the estimated value of donated labor was \$64.5 billion. *Id.* at 195. Given these statistics, it is likely that the inclusion of donated labor (in both the denominator and the numerator) would result in donations being a higher percentage of total revenues for most traditionally-exempt institutions.

<sup>229</sup> However, there is some doubt about education. Curiously, its Collectiveness Index dropped from 34% to 21% between Weisbrod's 1975 data and his 1980 data, and the latter figure consists of only 12% private giving (as opposed to the 9% of government grants that Weisbrod also included in his index). Compare Weisbrod, *Private Goods*, *supra* note 220, at 154, Table 3, with WEISBROD, NONPROFIT ECONOMY, *supra* note 23, at 197, Table C.4. Given the historic charitable status of educational institutions, we are somewhat troubled by the prospect that they might now fail the one-third threshold. Weisbrod did not speculate on the reasons for this change. However, an answer is suggested by observing that the earlier data was based upon a relatively small sample of 33 educational institutions, while the later data states that it is "by industry," evidently including all or nearly all organizations within the industry classification. Compare Weisbrod, *Private Goods*, *supra* note 220, at 154 with WEISBROD, NONPROFIT ECONOMY, *supra* note 23, at 197, Table C.4 and *id.* at 72 (noting that comprehensive sample of educational institutions for 1974-1977 included 9,160 institutions, including 1,400 libraries, as opposed to the 33 institutions sampled for the Collectiveness Index in Weisbrod's earlier work). It is likely that the smaller sample reflected more traditional privately-supported institutions, while the data from the entire industry is skewed by commercial nonprofit institutions such as vocational, preparatory or early childhood schools that in fact rely mostly on tuition income as a source of revenue. As we note below, *see infra* text accompanying notes 271-72, we would test exemption on an entity-specific, rather than industry-wide, basis. Therefore, it may well be that many educational institutions would continue to fare well under the one-third threshold, even though the educational sector as a whole does not meet this test. Moreover, we observe in the text at note 233, *infra*, that the threshold could be lowered for traditionally-exempt activities such as education on the grounds that we are more confident of their deservedness. Finally, we also observe in text and notes at notes 238-39, *infra*, the possibility of adopting a tiered approach to the tax subsidy that would still provide some lesser measure of tax benefits for institutions that fall below the basic threshold. See also *infra* note 249 (regarding tax treatment of institutions funded primarily by government grants). For all of these reasons, we are confident that many educational institutions would continue to receive some form of charitable tax exemption, which reinforces the historical consistency of the donative theory, although we would not be particularly surprised to find that some schools are no longer exempt.

<sup>230</sup> Actually, § 509(a) uses a threshold of "more than" one-third. For no other reason than ease of expression, we will stick with just one-third.

<sup>231</sup> We observe in favor of this threshold that, in contrast with the extreme disproportionality noted for a hypothesized one-tenth threshold, *supra* note 225 and accompanying text, the difference in subsidy effect per dollar of donation between a one-

We note, moreover, that considerable flexibility exists in designing the threshold while still taking into account the basic donative theory. The following modifications are possible. First, the one-third test could be applied to a *portion* of the entity seeking tax exemption. This would invite exempt entities to segregate their operations into units that meet the threshold. As long as such units meet the one-third threshold, no reason exists not to permit a subsidy *to that unit*.<sup>232</sup> Second, one might want to relax the one-third threshold to, say, twenty percent for certain categories of historically-exempt organizations, such as schools, churches, hospitals and the like, according to the reasoning that there is already some measure of confidence that these institutions are deserving and therefore are under less of a burden to demonstrate their worthiness and neediness for a subsidy.<sup>233</sup> Third, our support for the one-third threshold is drawn primarily from the federal income tax exemption, where a rather large percentage of nondonative revenue is necessary to create any significant subsidy effect.<sup>234</sup> Because the same is not

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third donative organization and a two-thirds donative organization would be only four-fold under the income tax exemption and two-fold under the property tax exemption, using the assumptions we stated earlier.

<sup>232</sup> Such segregation avoids the possibility of cross-subsidizing activities which do not need a subsidy, while permitting a subsidy for those activities that do.

<sup>233</sup> This is suggested by the regulations under § 170, which contain a “facts and circumstances” test that permits an entity to be classified as a public charity if it both receives 10% of its support from donations and demonstrates certain factors designed to show that the entity is responsive to public needs. Treas. Regs. § 1.170A-9(e)(3) (1986). However, we do not favor this route (and we think that 10% is too low in any event), since this exception is designed with a different purpose in mind. The facts and circumstances identified in this regulation attempt to identify organizations providing “community benefit” (for example, a governing body representative of the public at large), a test for exemption which we have explicitly rejected. See Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 358–79. Under the donative theory, it cannot be presumed that any particular activity is forever deserving of subsidy; each organization must continue to show its social worth and its need for a donative subsidy. Witness the example of hospitals, which we discuss at length in our prior article. Moreover, even among worthy charities, there is the continuing requirement of demonstrating neediness. Gergen argues persuasively that churches and synagogues suffer from less, not more, free riding than other traditional objects of donations; Gergen, *supra* note 23, at 1438; therefore, they should have to meet a *higher* threshold in order to deserve the same level of subsidy. In short, allowing certain classes of charities to qualify for the same set of tax benefits under a lower threshold would create a systemic disproportionality in the subsidy. A superior manner in which to apply the “facts and circumstances” exception to allow a relaxation of the threshold is to show that the gifts to a particular entity suffer from a greater degree of free riding than do most gifts generally, for reasons suggested *infra* notes 237–38 and accompanying text.

<sup>234</sup> See *supra* text accompanying notes 193–95.

necessarily true for the property tax exemption,<sup>235</sup> individual states may wish to set a higher threshold.<sup>236</sup>

Fourth, it is possible to treat differently under a single threshold gifts of a different nature. A single threshold assumes that all donations signal about the same level of worthiness and neediness, based on our analysis in Part II.A.3. that the motive for donations is not relevant to whether they deserve a subsidy *at all*, since some level of free riding attends all giving. But we did acknowledge in that section that motive might matter for purposes of determining the *amount* of subsidy.<sup>237</sup> One way to accommodate predictable variations (those that do not average out over donations and institutions generally) is to give less weight to donations that we conclude systematically suffer from less free riding by discounting them in the numerator of the one-third threshold.<sup>238</sup>

Finally, it is possible to depart from a uniform threshold by adopting a tiered approach to subsidizing charities, whereby varying degrees of tax benefit are conferred according to the level of donative support they demonstrate. This is already suggested by the present structure of the Code, which distinguishes between 501(c)(3) charitable organizations eligible to receive both an income tax exemption and tax deductible contributions, and 501(c)(4) "social welfare organizations," which are still tax exempt but lose their eligibility to receive deductible contributions.<sup>239</sup>

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<sup>235</sup> See *supra* note 194.

<sup>236</sup> However, we recommend sticking to a single threshold, since a 50-state variation would wreak havoc on charities. Moreover, given the modest subsidy effect created by the income tax exemption even for minimal, one-third donative institutions, it is reasonable to assume that a large base of exempt, nondonative property is necessary to fully overcome the market/government failure.

<sup>237</sup> See *supra* note 93 and accompanying text.

<sup>238</sup> Thus, one might contend that there is more willingness to give at death (or in contemplation of death) than during life since the donor does not have the alternative of personal consumption. (On the other hand, we have no confirmation for this speculation, and it may well be that legators value as strongly the desire to leave their wealth to their families as they value consuming it during life; indeed, spending on one's own family is usually considered a form of personal consumption.) Second, it might be shown that, for a given activity, donors are more willing to give to capital than to operating expenditures because, with the former, there is more of a lasting, tangible embodiment of one's altruism and therefore more psychic ("act utility") gratification. (Again, this is just speculation; we have no evidence.) Third, there is good reason to believe that, as between two equally-sized gifts, one from a rich donor is more easily given than from a poor donor. This would argue for differential accounting according to the wealth of donors, a rather complex proposition.

<sup>239</sup> See *supra* notes 170-71. Combining this observation with those just preceding, we might gingerly suggest a system in which different subsidies "kick in" at different donation levels as follows: at 10%, an entity qualifies for income tax exemption, but not donation-deductibility or property tax exemption; deductibility of donations and the other "charitable" income tax benefits could kick in at the 33% level; while full exemption

We stress, however, that each of these potential variations adds a considerable level of complexity. As we noted at the outset, with each increment of accuracy added to the system, one sacrifices a measure of ease in administration. Whether the trade-off is worth it is a value choice we leave to those in charge of determining and implementing public policy.

## 2. *Measuring Donations*

The second practical issue of implementation that arises is defining exactly what "counts" as a donation for purposes of computing the threshold. This overall issue, however, breaks into a number of subcomponents each of which can be examined separately.

### a. *Defining a Donation*

As noted earlier, a large body of case law in federal taxation has examined what constitutes a donation for purposes of the charitable contribution deduction under section 170 of the Code.<sup>240</sup> Although court decisions sometimes vary in their exact rationale, the key attribute of a donation is that no direct quid pro quo exists for the payment. As we previously have explained, this common-law definition of donation fits well with our donative theory.

The quid pro quo definition obviously excludes from the threshold payments for goods or services rendered by the entity in question. Similarly, it would exclude membership dues, since such payments are in exchange for the direct quid pro quo of membership privileges.<sup>241</sup> As a result, our measurement of the donation threshold would more closely track that used by section 170 than that used by section 509. Nevertheless, even the section 170 regulations include in the donation base certain items that we would exclude, such as government grants,<sup>242</sup> and they exclude certain items that we would include, such as donated labor. In addition, other aspects of calculating the donation

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(income, property and deduction) might be limited to organizations with over 50% donative support.

<sup>240</sup> See *supra* Part II.A.3.e.

<sup>241</sup> However, it would be appropriate to bifurcate membership dues when there clearly are both quid pro quo and donative elements to the "membership." For example, one becomes a "member" of the Metropolitan Opera Society by making a \$100 payment. This payment entitles a member to a biweekly magazine (*Opera News*) which otherwise would cost \$30 per year, and discounts on certain other merchandise. Clearly, a substantial portion of the dues are nothing more than a donation. See also Treas. Reg. § 1.170A-9(e)(7)(iii) (1986) (support includes membership fees unless fees are for the purpose of purchasing goods, services, access to facilities or the like).

<sup>242</sup> Treas. Reg. § 1.170A-9(e)(7)(i)(b) (1986).



threshold, such as whether to require breadth in donations and whether to differentiate capital gifts from gifts for operations must be examined.

b. *Donated Labor*

The reasons for the exclusion of donated labor from the definition of a publicly-supported entity under section 170 are unclear.<sup>243</sup> The donative theory would require inclusion of donated labor, in both the support base and the calculation of the donation threshold, for the simple reason that donation of services worth \$100 is as indicative of the need for subsidy as is the donation of \$100 in cash used to purchase the same services. Moreover, donated labor constitutes a very large percentage of the total value of private gifts to nonprofit institutions.<sup>244</sup>

Requiring an organization to value all its contributed services, however, would not only be a significant reporting burden, it also would be an open invitation to abusive overvaluing of those services in order to meet the contribution threshold. To ease the administrative problems, taxing authorities could adopt a standard valuation system, much as the IRS already has standard mileage rates for deduction of automobiles used for charity.<sup>245</sup> For instance, academic studies have valued donated labor by assuming that each worker could earn the average hourly wage of nonagricultural workers, plus twelve percent for fringe benefits.<sup>246</sup> While this is a relatively crude measure,<sup>247</sup> it indicates the possibility of constructing a standard valuation system.

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<sup>243</sup> Although the tax laws have long prohibited a *deduction* for contributed services, M. GRAETZ, *supra* note 65, at 487, this prohibition is based upon the technical argument that the charitable deduction requires a "payment," which can only be made in cash or other property. B. BITTKER & L. LOKKEN, *supra* note 95, ¶ 35.2.1, at 35-17. A more convincing theoretical basis of the prohibition is that allowing a deduction for contributed services without requiring the value of those services to be included in the income of the contributor results in a double tax benefit. *See, e.g.,* B. BITTKER & L. LOKKEN, *supra* note 95, at 35-17; M. GRAETZ, *supra* note 65, at 487. The exclusion of donated labor from the definition of a publicly-supported entity under § 170 or § 509, therefore, may simply have been out of a desire for statutory symmetry.

<sup>244</sup> Statistics cited by Weisbrod show that in 1985, the value of donated labor was \$110 million, as opposed to \$68 million of cash contributions for the 1984 year. WEISBROD, *NONPROFIT ECONOMY*, *supra* note 23, at 132-33.

<sup>245</sup> I.R.C. § 170(j) (1988) (12 cents per mile).

<sup>246</sup> WEISBROD, *NONPROFIT ECONOMY*, *supra* note 23, at 132.

<sup>247</sup> Under the donative theory, we believe that a more appropriate measure of the value of donated labor is what the labor would have cost the recipient on the market (as opposed to what the donor would have earned for the donated time), because this is a more appropriate measure of the "savings" in labor costs which can then be used to increase output of goods and services, and it is a fair estimate of the "opportunity cost" of a volunteer's time (e.g., what they would receive if they sold the same services in the labor market).

### c. Government and Private Grants

The donative theory dictates that government grants not be counted toward meeting the donative threshold.<sup>248</sup> While an entity dependent upon government grants for operational revenue clearly has experienced private market failure, government grants definitionally *negate* the existence of government failure, the second prong of the donative theory. A grant occurs because the democratic process (government) already has provided a mechanism for direct funding of the particular activity. Accordingly, government grants do not indicate a need for additional indirect subsidization through the tax system.<sup>249</sup>

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We do recognize that inclusion of donated labor could create administrative problems, especially in monitoring productivity. An entity "walking the line" on the donation threshold would be tempted to call for far more volunteers than it actually needs to staff the litter pick-up for the local park, since all the volunteers' time could be counted in the donation threshold calculation, regardless whether the volunteers were working a hard eight-hour day or picking up litter between conversations about the weather. A standard valuation system, however, could appropriately discount the value of the labor in certain categories to offset this tendency.

<sup>248</sup> Government grants, however, would be included in the denominator of the threshold fraction (gross revenues) since like other revenues, government grants provide funds to increase the output of goods and services and therefore negate government failure. *See generally supra* Part II.C.3. and Part III.B.1.

<sup>249</sup> We recognize that elimination of government grants from the calculation of the donation threshold would cause many research organizations currently exempt from tax under § 501(c)(3) to fail our test of exemption. Of course, the government might well decide to exempt grants from the tax base anyway, since it makes little sense for the government to tax its own money. As noted above, note 22, *supra*, we have no objection to the government deciding to found exemptions on bases other than the charitable status of the organization. One such separate basis for a noncharitable exemption is that the government should not tax itself. Such an exclusion could be crafted simply by excluding grants from income (which is not presently done, *see, e.g.*, I.R.C. § 102 (1988); *see generally* B. BITTKER & L. LOKKEN, *supra* note 95, chs. 10 & 11). Another possibility is to add such organizations to the list of entities in § 501(c)(4)-(26) that are granted exemption on some noncharitable basis. *Cf.* § 170(b)(1)(A)(iii) (1988) (singling out medical research organizations as qualifying for the higher deductibility limit).

Finally, one could exclude government grants from *both* the numerator and denominator of the donation threshold (as we propose for "innocent" disproportionate gifts, *see infra* text accompanying notes 259-63), thus permitting such organizations to meet the donation threshold independently of grants. Assume, for example, a research organization that receives \$900,000 in government grants and \$100,000 in private donations. While donations account for only 10% of total revenues of this organization, if the government grants are excluded from gross revenues, donations make up 100% of the narrowed revenue base. The argument for this treatment proceeds from a combination of the theory that the government should not tax its own money and of the donative theory. In essence, this hybrid approach attempts to avoid the "penalty" that occurs when an organization falls partly under both theories, but fails to qualify under either.

On the other hand, as is the case with current law, we would count grants from other private entities as donations. One might object that these gifts suffer from no free-rider disincentive because they are often made by private foundations organized under terms that *require* them to make gifts to certain causes.<sup>250</sup> But grants by private foundations are not entirely lacking in the ability to signal deservedness because, similar to the case for reputation-driven giving discussed in Part II.A.3.d., there are fewer such funds than the recipients who seek them. Therefore, a market in altruism is at work that assures us that such grants go to worthy causes and to those that the grantor perceives as being most needy.<sup>251</sup>

#### d. *Large Versus Small Gifts*

Earlier, we suggested the possibility of altering the measurement of donations to depart from a system that counts all donations equally in favor of one that weights some donations more than others.<sup>252</sup> The suggested rationale was that such an adjustment might be advisable to account for predictable variations in the degree of free riding that attends different types of gifts. The one area where we think the case for this adjustment is most compelling concerns the minimum number of donors necessary to achieve charitable status. A donative threshold that does not require a minimum breadth of support suffers under both the worthiness and the neediness criteria. The aberrational, idiosyncratic desires of a single individual may not reflect the desires of any significant portion of society and thus may not be worthy of a public subsidy.<sup>253</sup> Moreover, as the number of donors decreases, the risk of significant free riding, which in turn causes undersupply of the good or service, declines because factors such as peer pressure, group cohesiveness, implicit

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<sup>250</sup> This requirement might come not only from the trust instrument but also from tax law itself, which prohibits private foundations from engaging in excessive accumulation of earnings. I.R.C. § 4942 (1988) (excise tax on failure of private foundation to make minimum distributions). *See generally* P. TREUSCH, *supra* note 154, at 497–509.

<sup>251</sup> Still, there is a valid argument that gifts by private foundations suffer from less free riding, and therefore signal less neediness, than do other private gifts. Nevertheless, this concern is offset by observing that most private foundations themselves receive the vast majority of their assets from gifts, typically a single large donor. Therefore, they serve as donative conduits. That is, the signaling quality of the original gift should pass through to the foundation's distribution of that gift.

<sup>252</sup> *See supra* note 238 and accompanying text.

<sup>253</sup> The same point can be made in less absolute terms under the proportionality criterion. Even if a very large gift signals an activity valued by others, an idiosyncratic large donor may place a far greater value on the activity than do others. Therefore, even if the entity should be exempt to some extent, using that person's gift to form the entity's donative base would allow it to obtain a disproportionate subsidy by founding a much larger commercial, nondonative enterprise on the larger donative base.

reciprocity and other external inducements likely play a larger role in motivating the donation.<sup>254</sup> Thus the smaller the donative pool, the greater the probability that an additional government subsidy is not needed to provide the optimal level of goods and services.

On the other hand, the donative theory by definition primarily assists insular groups in society, since a widespread interest group presumably is better able to achieve direct government subsidy through the political system. Hence, requiring too great a number of donors would undermine the very purpose of the exemption to correct for government failure. Moreover, the donative theory creates no objections to large gifts per se,<sup>255</sup> only to a very few gifts being the virtual sole source of donative support for a single entity. For example, the donative theory applies with equal force to an entity that receives 100 percent of its \$100,000,000 in revenues from twenty gifts of \$5,000,000 as to one that receives \$1000 from twenty gifts of \$50. The concern is not with the absolute size of gifts but their size relative to the exempt entity's overall operations.

These considerations lead us to adopt some minimal "screening" device to weed out aberrational giving. A simple numerical test (such as requiring fifteen separate donors), however, does not serve the purpose, because it could be met with one \$20,000,000 gift and fourteen \$1 gifts. Obviously, such a situation is so close to a single donor that worthiness and neediness concerns (or, at least proportionality concerns)<sup>256</sup> are still present. Instead, a preferable system is one that both requires a minimum number of donations and guards against disproportionate gifts.

Fortunately, section 170 already contains such a system, including donations in the numerator of the threshold calculation only to the extent they do not exceed two percent of total support for the year.<sup>257</sup> This limitation effectively requires at least seventeen roughly equal donations in any one year

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<sup>254</sup> See generally *supra* Part II.A.3.

<sup>255</sup> We have no empirical evidence that the absolute size of a gift bears any predictable relation to worthiness or to a free-rider disincentive to give. As for worthiness, one might argue that a donative subsidy gives disproportionate weight to the hobbies of the rich, who obviously tend to make larger gifts. But, as discussed in the text accompanying notes 124-29, *supra*, the reciprocity inherent in the charitable exemption means that rich taxpayers will provide proportionally more tax support (in part due to the progressive tax rates, but even under a flat tax) for the favored activities of the poor. As for neediness, obviously, all things being equal, a large gift "hurts" more than a small one. However, one might speculate that larger gifts come from richer donors who are therefore more inclined to give, but, then again, they are giving more, so these two speculative possibilities tend to offset.

<sup>256</sup> See *supra* note 225.

<sup>257</sup> Treas. Reg. § 1.170A-9(e)(6) (1986).

to satisfy the threshold limitation.<sup>258</sup> Such a limitation appears well-suited to the purposes of the donative theory, with one important exception. The consequence of excluding ninety-eight percent of a disproportionately large gift from the numerator but not the denominator is to penalize, in effect, a charity for receiving a single large gift, since it is then more difficult for the remaining gifts to satisfy the one-third threshold.<sup>259</sup> An alternative approach to accounting for large gifts would be to exclude them from both halves of the fraction, thereby avoiding a penalty effect while also not counting them toward satisfying the threshold. In fact, the current regulations adopt this bifurcated approach, distinguishing between what might be called “innocent” disproportionate gifts and those that are “suspect,” according to criteria such as whether the donor is related to the organization’s management, whether the gift

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<sup>258</sup> Mathematically, the § 170 threshold will always require at least seventeen gifts. Under this section, the threshold is more than 33% of the total revenue base, or 33% of 100%. Since each donation “counts” only up to 2% of the revenue base, a minimum of seventeen 2%-gifts are needed to meet the threshold ( $17 \times 2 = 34$ ). The 2% limitation also guards against cases in which one gift is a disproportionate percentage of total donations. For example, assume an entity with \$1 million in total revenues. The 33% threshold will be met with seventeen \$20,000 gifts. The threshold will also be met with sixteen \$20,000 gifts and one \$500,000 gift. Suppose, however, that there is one gift of \$500,000 and sixteen gifts of \$100. In this case, the entity fails the threshold (33% of \$1 million is \$333,333. The \$500,000 gift counts in the numerator up to 2% of \$1 million, or \$20,000. The total numerator, therefore, is \$21,600, far less than the required one-third). Of course, the threshold also can be met with three hundred and twenty thousand \$1 gifts and one \$500,000 gift, but in this situation, the \$500,000 is not as disproportionate a percentage of total donations as it is in the case of the sixteen \$100 gifts.

We prefer this approach to the limit contained indirectly in § 509(a)(2), which credits donations to the extent of the greater of \$5000 or 2% of total donations over the life of the entity. Under the § 509(a)(2) system, an entity that had “built-up” a donation record could meet the threshold with very few large gifts in later years. Suppose, for example, that total donations to an entity for years 1–20 were \$20 million, and that in year 21 total revenues are \$1,200,000. The one-third test would be met in year 21 with a single donation of \$400,000; such a donation would be one-third of total support and would “count” in full since the donation does not exceed 2% of total donations for all years. In our view, an entity ought to demonstrate its need for subsidization on a regular basis and not be able to use prior donations to obtain an exemption forever. *See supra* Part II.A.5.

<sup>259</sup> Assume, for example, that a rich alumnus donates \$10,000,000 in a single year for a new university building, and that other donations (all less than \$10,000 each) equal \$500,000. Under our definitional scheme, the revenue base would be \$10,500,000 and the donations would count toward the threshold only to the extent of 2% of the base, or \$210,000. The total amount included in the threshold for this year, therefore, would consist of the small gifts totalling \$500,000 and \$210,000 of the \$10,000,000 grant, for a total of \$710,000, well below the one-third threshold. While this problem is ameliorated to some extent by the four-year average test of donative status used by current statutory provisions, *see infra* text accompanying notes 273–75, it may not cure it altogether.

is only tangentially relevant to its operations, and whether the organization would have met the threshold in the absence of the large gift.<sup>260</sup>

This bifurcation in the remedy for disproportionate gifts is well suited to the donative theory.<sup>261</sup> An "innocent" gift deserves more lenient treatment because it appears to be a true donation; therefore, there is some level of neediness, and some indication of worthiness comes from the fact that there are a sufficient number of other, smaller gifts supporting the activity to qualify it for donative status absent the gift. Thus, we would not want a rule that revoked an entity's charitable status merely because it happened to receive a very large gift one year. The only concern is one of proportionality—we do not wish a single, aberrational gift to determine the *size* of the subsidy by setting the donative base on which the organization might found a commercial, nondonative enterprise.<sup>262</sup> A "suspicious" gift, however, is one that either lacks entirely an independent indication of worthiness, or for which there are doubts about its neediness because of indications that there might be a hidden quid pro quo.<sup>263</sup> Such gifts therefore should be given the status of nondonative income rather than being simply ignored.

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<sup>260</sup> Treas. Reg. § 1.509(a)-3(c)(3) (1976).

<sup>261</sup> However, we would adopt somewhat different indicia for "innocent" versus "suspect" gifts. For instance, we would not give more credit to gifts by bequest than to inter vivos gifts, and we would add additional factors that attempt to ferret out hidden quid pro quos for a gift.

<sup>262</sup> Assume, for example, that an entity receives one \$1 million gift and sixteen \$100 gifts. If large gifts were counted in full in both the revenue base and in the donation threshold, the entity could use such a gift to receive an exemption on \$2 million of other income per the one-third threshold. On the other hand, if this gift is included in the revenue base but limited in counting toward the threshold to 2% of the revenues, the entity will fail the exemption test even though it received nothing but donations (total revenues of \$1,001,600, but "donations" of only roughly \$22,000 (\$1600 of small gifts and 2% of the large gift)). If the large gift is excluded from both the revenue base and the donation calculation, however, the entity is not penalized for having the large gift and also is not permitted to use the large gift to shield nondonative income. In the example, the entity would be 100% donative (revenue of \$1600, all from donations) but to meet the one-third threshold it could not have other income of more than \$3200 (in which case, total revenue would be \$4800, and it would just meet the one-third test).

<sup>263</sup> Nevertheless, disqualifying such gifts almost entirely (98% worth) based on these concerns is in tension with the analysis in Part II.A.3 that demonstrates that motive is irrelevant to whether donations deserve a tax subsidy. This tension can be resolved by observing that the prior analysis acknowledged possible doubts in its conclusions, which we set aside because of their minor nature in the run of donations and the administrative inconvenience of isolating the doubtful cases. Here, though, we have defined a class of doubtful cases for which the correct outcome is quite important (because of the size and determinative status of disproportionate gifts). Therefore, it is justifiable to, in effect, reverse the benefit of the doubt by disqualifying these gifts absent a demonstration that they are in fact "innocent." If this still seems to treat large gifts unduly, a compromise might be struck that counts such gifts entirely in the denominator but only to a discounted extent in

We also would keep two other exceptions to the breadth limitation that are part of current law. Both section 170 and section 509(a) credit grants from other publicly-supported entities in full toward the donation threshold (that is, these amounts are exempted from the two percent limit). We would keep a slightly-modified version of this exception and credit donations or grants from other donative entities in proportion to the entities' donative status (for instance, recipients of gifts from eighty percent donative institutions would be counted in the numerator at eighty percent of their value), following a conduit theory that attaches to gifts from tax-exempt donors the same deservedness-signalling qualities they possessed when they were originally given to the exempt donor for redistribution.<sup>264</sup>

Second, under a reverse conduit theory, we would exempt from the breadth limitations organizations that expend most of their income for the year as grants to donative entities. This exception would be similar to the current law's treatment of private operating foundations,<sup>265</sup> and is based upon our view that an entity that gives all its income each year to other organizations that have already established their worthiness and neediness does not itself need an independent check on worthiness and neediness. Since the donor institution is not itself engaging in any supply of an end good or service, it can be viewed simply as a holding tank for money and therefore engaged in the same activities as the donee institutions.

#### e. *Capital Assets Versus Operating Expenses*

Another important aspect of measuring the donative base is whether donations for capital projects, such as a new hospital wing, should "count" the same as donations to cover operating expenses, and, related to this issue, whether capital gifts should be credited over some time period (say, the

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the numerator, much as we suggest elsewhere the possibility of discounting other categories of gifts. *See supra* note 249.

<sup>264</sup> Moreover, the current statutory and regulatory schemes contain a number of "backup" rules which we would keep to avoid abuse. The regulations under § 170 and § 509(a)(2), for example, both state that "earmarked" gifts (i.e., gifts given to one entity which are earmarked for redistribution to a second entity) will be treated as having come from the original donor, and thus are not excepted from the breadth limitations. We would keep this rule under the donative theory to avoid end-runs around the breadth limitation through use of a donative entity conduit.

<sup>265</sup> I.R.C. §§ 170(b)(1)(A)(vii) and 170(b)(1)(E) give preferred status to "private operating foundations" as defined in I.R.C. § 4942(j)(3). To highly simplify an incredibly complex statute, private operating foundations are those foundations which expend virtually all their income each year in making grants to public charities. The statute, of course, provides exceptions to the general rule of mandatory distribution, such as permitting income accumulations for special projects. I.R.C. § 4942(g)(2) (1988). For a short general discussion of private operating foundations, see P. TREUSCH, *supra* note 154, at 567-72.

depreciation period of the asset they purchase) since presumably they are not "used up" during the current year. Our starting assumption is that each type of gift is equally worthy. Typically, an organization must have both a capital base and a means of meeting operating expenditures in order to produce goods and services. No significance should attach to the fact that a donation is used to purchase a building for Local U. rather than defraying the electric bill, because both are integral parts of the delivery by Local U. of its educational services. In fact, one can surmise that any given entity will "target" solicitations for donations to those areas in which the entity most needs help to continue its production of goods and services.<sup>266</sup>

On the other hand, because we favor an implementation of the donative theory that tests donative status on a periodic basis, proper measurement of the importance of donations to the output capacity of an entity in any one year suggests that some type of amortization system for capital gifts is appropriate. In effect, such a system attempts to match the portion of the donation used in a particular year for production of the undersupplied good or service to other revenues available that year. Moreover, because of the two percent limitation on counting gifts, simply including gifts for capital purchases in the year the donation is made might unfairly skew the donation threshold calculation for a year in which the entity receives a large donation.<sup>267</sup> We do not want a system that forces entities to structure donations to eliminate such skewing, such as by having the gift made in portions over a number of years.<sup>268</sup> Finally, common

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<sup>266</sup> As we have stated before, however, empirical or other evidence might show that a given class of gifts, such as gifts to capital campaigns, suffers proportionately less free-riding than other classes of gifts and therefore is less in need of an additional tax subsidy. The donative theory obviously can accommodate such variances by using separate thresholds for different classes of gifts, or by "weighting" such gifts in the calculation of the donation threshold differently. *See, e.g., supra* note 233.

<sup>267</sup> This skewing, however, exists only for gifts that are classified as "suspect," under the criteria discussed in text accompanying notes 260-63, *supra*, since "innocent" large gifts are excluded from both numerator and denominator. Thus, one might respond to the skewing concern that this effect is precisely what is intended for these kinds of gifts. However, the *degree* of skewing is unfair if it all occurs in a single year rather than being spread out over the economic life of the gift. The amortization remedy we adopt does not avoid all such skewing since even the amortized portion of a large capital gift could exceed the 2% threshold. If so, and if the gift fell into the "suspect" category, the amortized portion would still be treated under the rules set out above.

Observe also that the concern over *unfair* skewing does not exist for disproportionate gifts used for operating expenses (say, to pay off a whopping lawyer's bill), since in such cases the entity in fact receives the full economic benefit of the gift in a single year.

<sup>268</sup> Under § 509, items are included in the support denominator and the donation numerator for the threshold fraction under the cash method of accounting. Treas. Reg. § 1.509(a)-3(k) (1986). Thus a pledge for a contribution, even if legally binding, is not counted until actually received. *Id.* This permits an entity to spread one large contribution



intuition suggests that donors to capital campaigns view their gifts as having some measure of lasting effect—the current gift of \$1,000,000 to the children's hospital wing is prompted by the long-term nature of the asset purchased with the gift.

Amortizing capital gifts into the donation threshold fraction (both numerator and denominator) over some predefined period, such as the depreciation period for the assets purchased with the capital gift, solves each of these concerns.<sup>269</sup> This approach would avoid undue pressure to structure the donation as a series of several smaller gifts. It also is a better fit with the donative theory: to the extent that the amortization period approximates the economic useful life of the asset purchased, the tax subsidy is made more proportionate by being applied as the asset is expended in producing the undersupplied good or service rather than all in one year. Finally, amortizing this gift into the donation threshold calculation would more closely align the treatment of the gift for exemption purposes to the expectations of donors that their gift will in fact have an extended effect.

A third facet of this issue is how to count contributions made to endowment funds and the interest earned on those funds. A case can be made to treat gifts to an endowment similarly to capital gifts and to amortize them into the donation threshold calculation over some period of time. Donors to endowment funds, like donors to capital campaigns, probably believe their gift has a lasting quality. Moreover, like capital items, endowment funds are not “used up” in the current year. Such an approach, however, would present far more difficult issues of administration than amortizing capital gifts.<sup>270</sup>

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over a number of years, and we would presume that entities would choose this route as a matter of course if exempt status depended on it.

<sup>269</sup> The tax depreciation period is one obvious choice, although we are mindful that the tax depreciation system only rarely attempts to approximate economic useful life. The ADR system—in place prior to ACRS (and still used for certain definitional purposes)—might be a good starting point, since that system attempts to define an economic useful life. See generally B. BITTKER & L. LOKKEN, *supra* note 95, at ¶ 23.6.4. GAAP (Generally Accepted Accounting Principles) depreciation lives might be another starting point, although again we must consider the trade-off between administrative simplicity and theoretical purity.

Some accommodation would need to be made for assets that are not depreciable, such as land. Perhaps the cost of such capital items would be amortized over the longest available depreciation period.

<sup>270</sup> Whereas accounting for capital assets gifts easily plugs into depreciation schedules that exempt entities already keep for financial accounting purposes, amortization of endowment gifts would require creating new accounting systems that apply the amortization schedule to each year's gifts. This kind of annual segregation requirement would become an administrative nightmare. Moreover, an amortization system would have to account for what happens when endowment funds are used to meet extraordinary operating expenses: presumably, the unamortized amount of the gift would be immediately included in the denominator and numerator of the donation threshold calculation, but determining which

Therefore, we would count gifts to endowment in full in the year received.<sup>271</sup> Under this system, interest from endowment funds would be part of the gross revenue denominator of the threshold fraction, but would not be counted in the donation numerator (any more than rental income on a donated building would be).

### 3. *Timing and Identification Issues*

So far we have outlined the basic system for identifying donations and measuring them against an entity's revenue base. What remain are some general issues of implementation, such as whether the classification of donative entities should proceed on an individual or industry-wide basis, when the measurement of donative status should occur, and how to deal with start-up entities that have no support history.

#### a. *Implementing the Classification: Entity Versus Industry*

An industry-wide measurement has the advantage of the administrative simplicity of a one-for-all decision. What statistical compilations exist on donations generally are assembled on an industry-wide basis, permitting fairly easy implementation of such a system. Nevertheless, we believe that an entity-by-entity system is preferable.

To be valid, industry-wide data would have to come from reports by all or most of the individual industry participants; if each entity has to report its position for purposes of an industry-wide survey anyway, little administrative advantage is gained by avoiding scrutiny of specific entities. In addition, organizations may not be capable of convenient pigeonholing: exactly what sector is the United Way associated with, for example? Perhaps most important, however, is the fact that a given organization's support base may vary widely depending on its exact activities and geographic location. The

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funds are immediately included would require tracing the funds used or adoption of some accounting convention such as first-in-first-out.

<sup>271</sup> However, this presents the possibility of unduly penalizing recipients of large gifts to endowment—those that violate the 2% rule set forth in the text accompanying notes 257–59, *supra*. Like capital gifts, the penalty effect will be larger than the actual economic benefit of the gift in the time-span that the penalty is felt. *See supra* note 267. Therefore, there is a good case for modifying the approach just outlined in text to allow amortization of disproportionately large gifts to endowment that exceed the 2% limit. Observe, though, that this is an issue only for such gifts that are classified as “suspect,” which is more likely for the donation of capital assets than for the donation of cash. *See supra* note 260. Thus, there are likely to be few such exceptions. However, if the leader of a local Boy Scout Troop donates his limited partnership interest in a highly-depreciated Texas oil well and the Troop sells the interest to create an endowment, then it might be unfair to impose the entire penalty effect from this gift in a single year.

statistics for an entire industry say little about what funding situation a particular entity faces. For example, the hospital industry as a whole does not receive high levels of donative support, but a particular institution, or a particular service within many institutions, may be fully deserving of charitable status.<sup>272</sup> Finally, an entity-by-entity approach is already used in classifying publicly-supported organizations under the Code. The administrative machinery for individual decision-making, therefore, already exists in current law.

b. *When Is Donative Status Tested?*

The donative theory requires that entities justify their exemption on some regular basis. The fact that a charity received substantial donative support in one year does not preclude social conditions from changing in the future. In fact, the history of nonprofit hospitals recounted in our earlier work illustrates a dramatic shift from an industry reliant on donations to an industry reliant primarily on direct government subsidies and income from sale of services.<sup>273</sup> Accordingly, some mechanism is necessary to recheck entities periodically to ensure that they still meet the donative standard.

On the other hand, donation levels can vary for a given year, and it is perfectly possible that an entity can miss the threshold requirement in any one year but still meet it on an average basis over a number of years. Requiring an entity to meet the donation threshold every year would create undue pressure to structure donations so that little yearly variation occurs. Moreover, such a system would be unwieldy from the standpoint of yearly budgeting for managers of exempt entities: since in any given year an entity could “go taxable,” managers would have to plan for the possibility of tax payments which might or might not be due that year.

Some level of compromise between the necessity of periodic retesting and unwieldy “flip-flopping” is already a part of the Code scheme, however. The regulations under section 170 and section 509 both use a four-year average for the calculation of the public support threshold.<sup>274</sup> Moreover, once an entity meets this threshold, it is presumed to satisfy the public support test for the succeeding two years.<sup>275</sup> This system appears consistent with the donative theory.

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<sup>272</sup> For instance, Shriners hospitals, which care for children, rely almost entirely on donations, and cancer treatment for children seems to attract significant donative support for conventional hospitals. See Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 410 n.365.

<sup>273</sup> Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 400-03.

<sup>274</sup> Treas. Regs. §§ 1.170A-9(e)(4), 1.509(a)-3(c)(1) (1986). In each system whether an entity has met the threshold is determined on the basis of the aggregate revenue base and donation total for the previous four years.

<sup>275</sup> *Id.*

### c. *Start-Up Entities*

The final timing issue deals with the mechanism for handling start-up enterprises. Since by definition these entities have no operating history, they cannot demonstrate that they meet the donative threshold requirements. One method for handling such situations, of course, is simply to withhold tax-exempt status until the entity satisfies the donation threshold based upon past operations. Most studies of charitable contributions concede, however, that the tax deduction for contributions is critical to attracting donations;<sup>276</sup> accordingly, withholding exempt status and the corresponding deduction for contributions would put the entity at an unfair disadvantage in the market in altruism.

As a result, we favor a system that permits exemption on a trial basis, after which an entity would be required to meet the donation threshold on the basis of actual operations. Once again, we are guided by current law. The regulations under section 170 and section 509 permit newly-created organizations to apply for an advance ruling that essentially permits the entity to be classified as a public charity for a two or five year test period.<sup>277</sup> At the end of the test period, the entity must demonstrate that it meets the regular tests for publicly-supported status.<sup>278</sup> This procedure can be adapted wholesale to the donative theory.

## 4. *Exacerbation of Fundraising Abuse*

Another issue of practical implementation that demands some attention is the effect of the donative theory on fundraising abuse. Obviously, a system that keys tax exemption to a specific level of donative support encourages aggressive fundraising campaigns. We do not intend in this space to address the

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<sup>276</sup> See, e.g., WEISBROD, *NONPROFIT ECONOMY*, *supra* note 23, at 93-95 and sources cited therein; C. CLOTFELTER, *FEDERAL TAX POLICY AND CHARITABLE GIVING* 141 (1985) (noting that the absence of a tax exemption would result in a decrease in donations by about 25%).

<sup>277</sup> Treas. Regs. §§ 1.170A-9(e)(5), 1.509(a)-3(d) (1986).

<sup>278</sup> The test period ruling is granted on the basis of a facts and circumstances test which attempts to determine whether the entity's "organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public" that is necessary to meet the test of publicly-supported organizations. Treas. Regs. §§ 1.170A-9(e)(5)(ii), 1.509(a)-3(d)(2) (1986). The regulations list a number of factors to guide the decision, including breadth of public representation on the governing board of the entity, breadth of initial funding, size of initial endowment, plans for fundraising solicitation and the like. Treas. Regs. §§ 1.170A-9(e)(5)(ii) (1986) (cross-referencing § 1.170A-9(e)(3)), 1.509(a)-3(d)(2) (1986) (cross-referencing § 1.509(a)-3(a)).

legal aspects of regulation of fundraising by charitable organizations, a subject that has been examined by economists and legal commentators.<sup>279</sup> We note, however, that the abuse that has engendered the most legislative action and critical commentary is the problem of excessive costs of fundraising—that is, a charitable entity that spends a very small portion of a donation on delivery of charitable services, with the lion's share covering the costs of fundraising itself.<sup>280</sup> A donative system that counted donations toward the threshold regardless of the associated costs clearly would exacerbate the excessive cost problem, since there would be every incentive to spend up to 100 percent of receipts on fundraising. In fact, one can hypothesize situations in which fundraising costs *exceeding* 100 percent of donations would be rational, since the gross donations so generated might trigger the donative threshold and result in tax savings that exceed the fundraising costs.<sup>281</sup>

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<sup>279</sup> A recent comprehensive treatment of the legal aspects of charitable fundraising is that of Espinoza, *Straining the Quality of Mercy: Abandoning the Quest for Informed Charitable Giving*, 64 S. CAL. L. REV. 605 (1991). Other discussions include Rose-Ackerman, *Charitable Giving and "Excessive" Fundraising*, 97 Q.J. ECON. 193 (1982); Note, *Regulation of Charitable Fundraising: Riley v. National Federation of the Blind of North Carolina*, 24 U.S.F.L. REV. 205 (1989) [hereinafter Note, *Regulation of Charitable Fundraising*]; Note, *Charitable Fraud in New York: The Role of the Professional Fund Raiser*, 33 N.Y.L. SCH. L. REV. 409 (1988) [hereinafter Note, *Charitable Fraud in New York*]; Note, *Secretary of State v. Joseph H. Munson Co.: State Regulation of Fundraising Costs*, 5 PACE L. REV. 489 (1985) [hereinafter Note, *State Regulation of Fundraising Costs*].

<sup>280</sup> Espinoza, *supra* note 279; Note, *Regulation of Charitable Fundraising*, *supra* note 279, at 210; Note, *Charitable Fraud in New York*, *supra* note 279, at 411–12; Note, *State Regulation of Fundraising Costs*, *supra* note 279, at 495–97; see *Organized Charities Pass Off Mailing Costs As "Public Education," Wall St. J.*, Oct. 29, 1990, at A1 (noting that 90% of money raised by the Doris Day Animal League is used for further fundraising, specifically for direct mail campaigns). See generally *Charities and Nonprofit Organizations: What You Get When You Give, Hearings Before the Subcomm. on Antitrust, Monopolies and Business Rights*, 101st Cong., 1st Sess. (1989). These abuses, however bad, do not defeat the case for the donative theory because they are no worse than those that afflict market and government mechanisms, which are the primary alternatives. Moreover, the donative theory may help focus attention on the need for further reforms.

<sup>281</sup> Assume, for example, that an entity has gross revenues of \$1000, none of which are from donations, and has taxable income after expenses of \$100. The entity owes federal tax of \$34 under the current maximum corporate tax rate of 34%. Donations to the entity of \$500 under our system would invoke charitable status and a tax exemption, saving the entity \$34 in taxes. If the gross donations counted toward the one-third threshold, presumably the entity would pay up to \$534 for fundraising services. That is, at a cost of \$534, the fundraising campaign "breaks even" producing zero net return (a cost of \$534, offset by additional revenues of \$500 and a tax savings of \$34).

Professor Espinoza notes a number of other situations in which charities may engage in fundraising campaigns where costs exceed the amount raised. For example, a charity may want to present a "successful image" by raising as much money as possible regardless of

The obvious solution to this problem is to count only "net" donations in the threshold amount. A net system also provides incentives for the entity to engage in the most cost-effective fundraising, since gross donations will be included in the total revenue base and will cause a "gross-up" effect that makes meeting the threshold harder as proportionate fundraising costs rise.<sup>282</sup> A system that counts only the net donation also better matches the level of tax subsidy to the level of deservedness by insuring that the tax subsidy is not provided to entities whose primary activity is fundraising.<sup>283</sup> While this system probably would not eradicate the excess cost problem, at least it insures that the donative theory does not erode the general economic incentive to control costs in order to maximize revenues.

### 5. Controlling Political Activity

As noted earlier, political activities by exempt organizations raise many of the same issues as fundraising expenses.<sup>284</sup> In a sense, political activity is a form of fundraising, since much, if not all, such activity will be directed toward improving the financial fortunes of the entity. While the current Code scheme provides a type of compromise on political activity, permitting some types of legislative lobbying to some degree, but prohibiting political campaign

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cost. Espinoza, *supra* note 279, at 653. Or a charity might rationally engage in a donor acquisition program where costs exceed the actual donations. *Id.* at n.233. In the latter case, the charity presumably believes that once the donor is "hooked," future contributions will offset the current excess expenses.

<sup>282</sup> Again, take the example set forth in note 281. To meet the one-third threshold on a net basis, the amount of gross donations needed varies with the fundraising cost. Assume that fundraising costs are 50% of donations. In order to meet the one-third threshold, gross donations would have to be at least \$2000 (the gross donations would increase total revenues to \$3000, one-third of which is \$1000, which is the net donation amount in the example). If fundraising costs are only 10%, then the gross donations needed to meet the threshold would go down to \$590 (gross revenues are now \$1590, one-third of which equals \$530, and net donations are \$531). Put algebraically, the gross donations needed to meet the threshold can be calculated using the following formula:

$$1/3(\text{GR} + \text{D}) = \text{FRC} \times \text{D}$$

where GR is the gross revenues not including donations, D is the gross donation amount, and FRC is the fundraising cost expressed as a percentage of donations.

As Professor Espinoza has pointed out, classifying expenditures of an entity as "fundraising" costs versus expenditures on charitable programs raises an inherently difficult, but not insurmountable, problem of classification and accounting. Espinoza, *supra* note 279, at 656-63.

<sup>283</sup> Cf. Espinoza, *supra* note 279, at 672-73 ("Congress could declare that fundraising, like lobbying, while a legitimate charitable activity, is of such low public benefit that it should not be subsidized through the tax exemption and deductibility system.").

<sup>284</sup> See *supra* note 178 and accompanying text.

activity,<sup>285</sup> the donative theory permits a simpler mechanism for checking political expenditures. As with fundraising costs, the donation threshold could be calculated by deducting political activity costs from donations for purposes of computing the donative threshold. This netting calculation produces the same incentive to limit lobbying costs as it does to limit fundraising costs,<sup>286</sup> while avoiding substance-based regulation.<sup>287</sup>

### C. Summary of Practical Implementation

To summarize, we would apply the donative test on an entity-by-entity basis, using a donation threshold of one-third of total revenues to classify charitable organizations eligible for tax exemption.<sup>288</sup> This is essentially the same procedure and threshold tests used by current law in defining publicly-supported organizations. We would define total revenues in generally the same manner as is already done in section 509(d), but would include gains from capital asset sales. The donation threshold calculations would include all those items currently included for purposes of section 170(b) other than government grants and would continue to limit the amount any one donation "counted" in the threshold to two percent of the gross revenues for the year. Because of the overall importance of donated labor to judging the level of public support of an organization, we would add labor to the donation threshold calculation (both numerator and denominator) using a standard valuation system. Unlike current law, we would amortize gifts for capital purchases into both numerator and denominator over a predefined time period, such as the asset's depreciation period. We also suggest a number of other possible refinements that could be adopted, depending on the results from further empirical inquiry into altruistic behavior and depending on regulators' appetites for accuracy over simplicity.

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<sup>285</sup> See *supra* text accompanying notes 170-73. As noted earlier, we can see no reason to treat political activity such as campaigning differently from lobbying, inasmuch as both are methods for accomplishing a given goal: improvement of the fortunes of the entity engaged in the political activity. One of the strengths of the donative theory is that normative judgments regarding "good" and "bad" activities for a charity, such as "good" and "bad" political activity, can be eliminated.

<sup>286</sup> See *supra* notes 282-83.

<sup>287</sup> Obviously, determining what costs are attributable to "political activity" will require some administrative definition, but current law already requires identifying certain such expenditures for purposes of the I.R.C. § 501(h) safe-harbor rule regarding lobbying.

<sup>288</sup> As noted in the text, we would also adopt the four-year average approach of current law to compensate for fluctuations in gifts that could adversely affect the calculation of the donation threshold, and we would adopt the advance ruling procedure of current law for start-up entities. Moreover, to help control fundraising abuses and political activity, we would calculate the threshold with reference to the "net" donations (that is, the excess of donations over fundraising expenses and political activity expenses).

Given the amount of material that can be adapted from current statutes and regulatory procedures, implementing the donative theory would not require major overhaul of the tax system.<sup>289</sup> The significance of the change, however, should not be minimized: the proposed system would completely replace the current system of administering exemptions under section 501(c)(3), eliminating activity-specific judgments of "community benefit," "commercial manner," "relatedness" and the like in favor of more bright-line, quantitative tests for donative status. Although our proposed system borrows heavily from federal tax law, states could piggyback on the system by either copying the federal statutes or by conferring charitable status automatically on anyone that receives federal approval, as is already the case with most state income tax laws.

#### IV. CONCLUSION

This paper demonstrates both the powerful explanatory force of the donative theory and its relative ease of administration. The theory gains force from its generalizeability: it applies to any (significant) instance of giving, regardless of the particular subjective motive and regardless of the nature of the market and government defects that give rise to the need to donate. The theory is also remarkable for its ability to internalize the explanation for various restrictions on exempt entities to the core justification of the exemption, rather than maintaining these restrictions based on ad hoc, external concerns. The donative theory eases the burdens of administration by employing a market-like mechanism to measure the social worth and need of various organizations automatically, without the intervention of social value judgments made by revenue agents. The designation of donative thresholds and the measurement of actual donations entail several complexities, but they can be just as easily handled as the designation and measurement problems present under the conventional conception of the exemption; indeed, most aspects of the existing regulations are remarkably adaptable to this task.

Adoption of the donative theory—or, more accurately, its recognition, since it can be revealed to be in place already—will solve all of the major pending controversies surrounding the charitable exemption. The most recent controversy at the federal level is the legislative debate over the tax-exempt status of nonprofit hospitals.<sup>290</sup> This skirmish masks a more elemental unease

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<sup>289</sup> For clarity, we reiterate that the proposed system of identifying 501(c)(3) organizations would replace the current analysis and would not permit any "presumptive" categories of donative entities. That is, churches, hospitals and certain educational institutions automatically would have to prove their own case for exemption.

<sup>290</sup> The 1991 legislative calendar saw introduction of two separate bills designed to further regulate the tax exempt status of nonprofit hospitals. *See* H.R. 790, 102d Cong., 1st Sess. (1991); H.R. 1374, 102d Cong., 1st Sess. (1991). *See generally* Colombo & Hall, *The*



about the basic justification for the exemption itself and whether the commercialization of nonprofits should affect their exemption, an issue reflected in earlier federal hearings on the UBIT.<sup>291</sup> The donative theory readily provides the following answers: the charitable exemption is a means for providing a shadow subsidy to activities that donations signal as being socially worthy and in need of further support; the concerns underlying the UBIT are valid but the tax itself is unnecessary under a scheme that adjusts for the proper relationship between exempt and nonexempt functions by setting a threshold that requires a substantial donative base; some degree of commercialization by nonprofits is necessary in order for the charitable exemption to create a subsidy effect under the income tax; excessive commercialization dwarfing the donative base undermines exempt status because it indicates the organization, however worthy, is no longer suffering from market failure and therefore needs no additional subsidy. The foregoing is precisely what has occurred in the hospital industry over the past generation and so, apart from isolated institutions, or particular services, they no longer deserve charitable status under this approach.<sup>292</sup>

This is not to say that the donative theory is the only plausible basis on which a tax exemption might be conferred, or that society necessarily must confer an exemption at all. We would not stand in opposition if our legislators chose explicitly to restrict the charitable exemption to organizations that assist the poor, or if they chose to repeal the exemption altogether in favor of a more direct form of social subsidy. To this extent, the donative theory is not a "strong" justification for the exemption that precludes all other possibilities. We have meant only to demonstrate that, among plausible accounts, the donative theory best explains the form of tax exemption that our legislators have in fact chosen. No other theory as successfully explains: (1) what charities are consistent with the common sense understandings and the 400 years of legal history that lie behind this concept; and (2) why they are (a) eligible to receive tax exempt donations, and (b) exempt from both (i) property and (ii) income taxation, but (c) only to the extent of their related income and property, and (d) only if they (i) are nonprofit, (ii) do not violate public policy, and (iii) do not engage in excessive political activity. A theory that can provide a satisfactory,

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*Future of Tax Exemption for Hospitals and Other Health Care Providers*, 2 HEALTH MATRIX (forthcoming Spring 1992).

<sup>291</sup> *Unrelated Business Income Tax, Hearings Before the House Subcommittee on Oversight of the House Committee on Ways and Means*, 100th Cong., 1st Sess. 3-4 (1987).

<sup>292</sup> However, we do not oppose granting hospitals exemption under the charity care theory if they in fact demonstrate that they provide uncompensated care over and above what similar for-profit hospitals provide, sufficient to earn the total value of the exemption. See Hall & Colombo, *Nonprofit Hospitals*, *supra* note 6, at 357 n.198; Colombo & Hall, *supra* note 290 (manuscript at 52, on file with authors). An approach similar to this has been proposed in recent legislation, although the technical problems in this bill are numerous. See *id.* (manuscript at 21-28, on file with authors).

integrated explanation for each of these components of the present scheme of tax exemption is too compelling to ignore unless we are willing to abandon altogether the concept of a charitable exemption.